DESCRIPTION OF AN AMENDMENT IN THE NATURE OF A SUBSTITUTE TO THE CHAIRMAN'S MARK RELATING TO TAX SIMPLIFICATION PROPOSALS

Scheduled for Markup

by the

HOUSE COMMITTEE ON WAYS AND MEANS

on September 18, 1995

Prepared by the Staff

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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Committee on Ways and Means has scheduled a markup of tax simplification proposals on September 18, 1995. This document, prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's mark on tax simplification.[1]

Each item includes a description of present law, the proposal, effective date, and legislative background on recent Congressional or Committee action on the proposal.

Tax simplification provisions were reported by the Committee on Ways and Means in 1993 (H.R. 3419, 103rd Cong., H. Rept. 103-353, November 10, 1993) and passed by the House of Representatives on May 17, 1994. Also, tax simplification provisions were included in H.R. 11 (102nd Cong.) and H.R. 4210 (102nd Cong.), as passed by the House and Senate in 1992 and vetoed by President Bush.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of an Amendment in the Nature of a Substitute to the Chairman's Mark Relating to Tax Simplification Proposals* (JCX-35-95), September 18, 1995.

DESCRIPTION OF TAX SIMPLIFICATION PROPOSALS

I. SIMPLIFICATION PROVISIONS RELATING TO INDIVIDUALS

A. Rollover of Gain on Sale of a Principal Residence

Present Law

No gain is recognized on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of section 1034.

In general, nonrecognition treatment is available only once during any two-year period. In addition, if the taxpayer purchases more than one residence during the replacement period and such residences are each used as the taxpayer's principal residence within two years after the date of sale of the old residence, only the last residence so used is treated as the replacement residence.

Special rules apply, however, if residences are sold in order to relocate for employment reasons. First, the number of times nonrecognition treatment is available during a two-year period is not limited. Second, if a residence is sold within two years after the sale of the old residence, the residence sold is treated as the last residence used by the taxpayer and thus as the only replacement residence.

The determination whether property is used by a taxpayer as a principal residence depends upon all the facts and circumstances in each case, including the good faith of the taxpayer. No safe harbor is provided for sales of principal residences incident to divorce or marital separation.

Description of Proposals

Multiple rollovers

Under the proposal, gain would be rolled over from one residence to another residence in the order the residences are purchased and used, regardless of the taxpayer's reasons for the sale of the old residence. In addition, gain may be rolled over more than once within a two-year period. Thus, the rules that formerly applied only if a taxpayer sold his residence in order to relocate for employment purposes would apply in all cases. As under present law, the basis of each succeeding residence would be reduced by the amount of gain not recognized on the sale of the prior residence.

Rollovers in the case of divorce or separation

The proposal would provide a safe harbor in the determination of principal residence in certain cases incident to divorce or marital separation. Specifically, the bill would provide that a residence is treated as the taxpayer's principal residence at the time of sale if (1) the residence is sold pursuant to a divorce or marital separation and (2) the taxpayer used such residence as his or her principal residence at any time during the two-year period ending on the date of sale.

Effective Date

The proposals would apply to sales of old residences (within the meaning of sec. 1034) after the date of enactment.

Legislative Background

The proposals were included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposals also were included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

B. One-Time Exclusion on the Sale of a Principal Residence by an Individual Who Has Attained Age 55

Present Law

In general, a taxpayer may exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale, and (2) has used the residence as a principal residence for three or more years of the five years preceding the sale. This election is allowed only once in a lifetime unless all previous elections are revoked. For these purposes, sales on or before July 26, 1978 are not counted against the once in a lifetime limit.

Description of Proposal

The proposal would allow an exclusion to an individual who otherwise qualifies but for a marriage to a spouse with existing election in effect. The exclusion would only be available if the individual held the property which is the subject of the exclusion for at least three years prior to marrying the spouse with the existing exclusion.

Effective Date

The proposal would be effective for sale or exchanges after September 13, 1995.

C. Other Individual Simplification Provisions

1. Permit payment of taxes by any commercially acceptable means

Present Law

Payment of taxes may be made by checks or money orders, to the extent and under the conditions provided by regulations.

Description of Proposal

In general

The Internal Revenue Service (IRS) is engaged in a long-term modernization of its information systems, the Tax Systems Modernization (TSM) Program. This modernization is intended to address deficiencies in the current IRS information systems and to plan effectively for future information system needs and requirements. The systems changes are designed to reduce the burden on taxpayers, generate additional revenue through improved voluntary compliance, and achieve productivity gains throughout the IRS. One key element of this program is electronic filing of tax returns.

At the present time, increasing reliance is being placed upon electronic funds transfers for payment of obligations. In light of this, the IRS seeks to integrate these payment methods in its TSM program, including electronic filing of returns, as well as into its traditional collection functions. The proposal would allow the IRS to accept payment by any commercially acceptable means that the Secretary deems appropriate, to the extent and under the conditions provided in Treasury regulations. This would include, for example, electronic funds transfers, including those arising from credit cards, debit cards, and charge cards.

The proposal contemplates that the IRS would proceed to negotiate contracts to implement this provision with one or more private sector credit, debit, and/or charge card systems. The proposal would provide that in no event would the Federal Government pay any fees with respect to any such contracts.

Billing error resolution

In the course of processing these transactions, it would be necessary to resolve billing errors and other disputes. The Internal Revenue Code contains mechanisms for the determination of tax liability, defenses and other taxpayer protections, and the resolution of disputes with respect to those liabilities. The Truth-in-Lending Act contains provisions for determination of credit card liabilities, defenses and other consumer protections, and the resolution of disputes with respect to these liabilities.

The proposal would exclude credit card, debit card, and charge card issuers and processing mechanisms from the resolution of tax liability, but would make the IRS subject to the Truth-in-Lending provisions insofar as those provisions impose obligations and responsibilities with regard to the "billing error" resolution process. It is not intended that consumers would obtain additional ways to dispute their tax liabilities under the Truth-in-Lending provisions.

The proposal would also specifically include the use of debit cards in this provision and provide that the corresponding defenses and "billing error" provisions of the Electronic Fund Transfer Act would apply in a similar manner.

The proposal would add new section 6311(d)(3) to the Code. This section would describe the circumstances under which section 161 of the Truth-in-Lending Act ("TILA") and section 908 of the Electronic Fund Transfer Act ("EFTA") would apply to disputes that may arise in connection with payments of taxes made by credit card or debit card. Subsections (A) through (C) recognize that "billing errors" relating to the credit card account, such as an error arising from a credit card transaction posted to a cardholder's account without the cardholder's authorization, an amount posted to the wrong cardholder's account, or an incorrect amount posted to a cardholder's account as a result of a computational error or numerical transposition, would be governed by the billing error provisions of section 161 of TILA. Similarly, subsections 6311(d)(3)(A)-(C) would provide that errors such as those described above which would arise in connection with payments of internal revenue taxes made by debit card, would be governed by section 908 of EFTA.

The Internal Revenue Code provides that refunds would be only authorized to be paid to the person who made the overpayment (generally the taxpayer). Subsection 6311(d)(3)(E), however, would provide that where a taxpayer is entitled to receive funds as a result of the correction of a billing error made under section 161 of TILA in connection with a credit card transaction, or under section 908 of EFTA in connection with a debit card transaction, the IRS would be authorized to utilize the appropriate credit card or debit card system to initiate a credit to the taxpayer's credit card or debit card account. The IRS would, therefore, provide such funds through the taxpayer's credit card or debit card account rather than directly to the taxpayer.

On the other hand, subsections 6311(d)(3)(A)-(C) would provide that any alleged error or dispute asserted by a taxpayer concerning the merits of the taxpayer's underlying tax liability or tax return would be governed solely by existing tax laws, and would not be subject to section 161 or section 170 of TILA, section 908 of EFTA, or any similar provisions of State law. Absent the exclusion from section 170 of TILA, in a collection action brought against the cardholder by the card issuer, the cardholder could otherwise assert as a defense that the IRS had incorrectly computed his tax liability. A collection action initiated by a credit card issuer against the taxpayer/cardholder would be an inappropriate vehicle for the determination of a taxpayer's tax liability, especially since the United States would not be a party to such an action.

Similarly, without the exclusion from section 161 of TILA and section 908 of EFTA, a taxpayer could contest the merits of his tax liability by putting the charge which appears on the

credit card bill in dispute. Pursuant to TILA or EFTA, the taxpayer's card issuer would have to investigate the dispute, thereby finding itself in the middle of a dispute between the IRS and the taxpayer. It is believed that it is improper to attempt to resolve tax disputes through the billing process. It is also noted that the taxpayer retains the traditional, existing remedies for resolving tax disputes, such as resolving the dispute administratively with the IRS, filing a petition with the Tax Court after receiving a statutory notice of deficiency, or paying the disputed tax and filing a claim for refund (and subsequently filing a refund suit if the claim is denied or not acted upon).

Creditor status

The TILA would impose various responsibilities and obligations on creditors. Although the definition of the term "creditor" set forth in 15 U.S.C. sec. 1602 is limited, and would generally not include the IRS, in the case of an open-end credit plan involving a credit card, the card issuer and any person who honors the credit card would be, pursuant to 15 U.S.C. sec. 1602(f), creditors.

In addition, 12 CFR sec. 226.12(e) provides that the creditor must transmit a credit statement to the card issuer within 7 business days from accepting the return or forgiving the debt. There is a concern that the response deadlines otherwise imposed by 12 CFR sec. 226.12(e), if applicable, would be difficult for the IRS to comply with (given the volume of payments the IRS is likely to receive in peak periods). This could subject the IRS to unwarranted damage actions. Consequently, the proposal generally would provide an exception to creditor status for the IRS.

Privacy protections

The proposal would also address privacy questions that would arise from the IRS' participation in credit card processing systems. It is believed that taxpayers would expect that the maximum possible protection of privacy will be accorded any transactions they have with the IRS. Accordingly, the bill would provide the greatest possible protection of taxpayers' privacy that is consistent with developing and operating an efficient tax administration system. It is expected that the principle will be fully observed in the implementation of this provision.

A key privacy issue is the use and redisclosure of tax information by financial institutions for purposes unrelated to the processing of credit card charges, i.e., marketing and related uses. To accept credit card charges by taxpayers, the IRS would have to disclose tax information to financial institutions to obtain payment and to resolve billing disputes. To obtain payment, the IRS would have to disclose, at a minimum, information on the "credit slip," i.e., the dollar amount of the payment and the taxpayer's credit card number.

The resolution of billing disputes may require the disclosure of additional tax information to financial institutions. In most cases, providing a copy of the credit slip and verifying the transaction amount would be sufficient. Conceivably, financial institutions could require some information regarding the underlying liability even where the dispute concerns a "billing dispute"

matter. This additional information would not necessarily be shared as widely as the initial payment data. In lieu of disclosing further information, the IRS could elect to allow disputed amounts to be charged back to the IRS and to reinstate the corresponding tax liability.

Despite the language in most cardholder agreements that permits redisclosure of credit card transaction information, the public may be largely unaware of how widely that information is shared. For example, some financial institutions may share credit, payment, and purchase information with private credit bureaus, who, in turn, may sell this information to direct mail marketers, and others. Without use and redisclosure restrictions, taxpayers may discover that some traditionally confidential tax information might be widely disseminated to direct mail marketers and others.

It is intended that credit or debit card transaction information would generally be restricted to those uses necessary to process payments and resolve billing errors, as well as other purposes that are specified in the statute. The proposal would direct the Secretary to issue published procedures on what constitutes authorized uses and disclosures. It is anticipated that the Secretary's published procedures would prohibit the use of transaction information for marketing tax-related services by the issuer or any marketing that targets only those who use their credit card to pay their taxes. It is also anticipated that the published procedures would prohibit the sale of transaction information to a third party.

Effective Date

The proposal would be effective nine months after the date of enactment. The IRS may, in this interim period, conduct internal tests and negotiate with card issuers, but may not accept credit or debit cards for payment of tax liability.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

2. Simplified foreign tax credit limitation for individuals

Present Law

In order to compute the foreign tax credit, a taxpayer computes foreign source taxable income and foreign taxes paid in each of the applicable separate foreign tax credit limitation categories. In the case of an individual, this requires the filing of IRS Form 1116, designed to elicit sufficient information to perform the necessary calculations.

In many cases, individual taxpayers who are eligible to credit foreign taxes may have only a modest amount of foreign source gross income, all of which is income from investments (e.g., dividends from a foreign corporation subject to foreign withholding taxes or dividends from a domestic mutual fund that can pass through its foreign taxes to the shareholder (see sec. 853)). Taxable income of this type ordinarily is subject to the single foreign tax credit limitation category known as passive income. However, under certain circumstances, the Code treats investment-type income (e.g., dividends and interest) as income in several other separate limitation categories (e.g., high withholding tax interest income, general limitation income) designed to accomplish certain policy objectives or forestall certain abuses. For this reason, any taxpayer with foreign source gross income is required to provide sufficient detail on Form 1116 to ensure that foreign source taxable income from investments, as well as all other foreign source taxable income, is allocated to the correct limitation category.

Description of Proposal

The proposal would allow individuals with no more than $200 ($400 in the case of married persons filing jointly) of creditable foreign taxes, and no foreign source income other than passive income, to elect a simplified foreign tax credit limitation equal to the lesser of 25 percent of the individual's foreign source gross income or the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year. (It is intended that an individual electing this simplified limitation calculation would not be required to file Form 1116 in order to obtain the benefit of the credit.) A person who elects the simplified foreign tax credit limitation would not be allowed a credit for any foreign tax not shown on a payee statement (as that term is defined in sec. 6724(d)(2)) furnished to him or her. Nor would the person be entitled to treat any excess credits for a taxable year to which the election applied as a carryover to another taxable year. Because the limitation for a taxable year to which the election applies can be no more than the creditable foreign taxes actually paid for the taxable year, it would also be the case under the proposal that no excess credits from another year may be carried over to the taxable year to which the election applies.

For purposes of the simplified limitation, passive income generally would be defined to include all types of income that would be foreign personal holding company income under the subpart F rules, plus income inclusions from foreign personal holding companies and passive foreign investment companies, so long as the income is shown on a payee statement furnished to the individual. Thus, for purposes of the simplified limitation, passive income would include all dividends, interest (and income equivalent to interest), royalties, rents, and annuities; net gains from dispositions of property giving rise to such income; net gains from certain commodities transactions; and net gains from foreign currency transactions that give rise to foreign currency gains and losses as defined in section 988. The statutory exceptions to treating these types of income as passive for foreign tax credit limitation purposes, such as the exceptions for high-taxed income and high-withholding-tax interest, would not be applicable in determining eligibility to use the simplified limitation.

Although an estate or trust generally computes taxable income and credits in the same manner as in the case of an individual (Code sec. 641(b); Treas. Reg. sec. 1.641(b)-1), the simplified limitation would not apply to an estate or trust.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

3. Treatment of personal transactions by individuals in foreign currency

Present Law

When a U.S. taxpayer with a U.S. dollar functional currency makes a payment in a foreign currency, gain or loss (referred to as "exchange gain or loss") arises from any change in the value of the foreign currency relative to the U.S. dollar between the time the currency was acquired (or the obligation to pay was incurred) and the time that the payment is made. Gain or loss results because foreign currency, unlike the U.S. dollar, is treated as property for Federal income tax purposes.

Exchange gain or loss can arise in the course of a trade or business or in connection with an investment transaction. Exchange gain or loss can also arise where foreign currency was acquired for personal use. For example, the IRS has ruled that a taxpayer who converts U.S. dollars to a foreign currency for personal use--while traveling abroad--realizes exchange gain or loss on reconversion of appreciated or depreciated foreign currency (Rev. Rul. 74-7, 1974-1 C.B. 198).

Prior to the Tax Reform Act of 1986 ("1986 Act"), most of the rules for determining the Federal income tax consequences of foreign currency transactions were embodied in a series of court cases and revenue rulings issued by the IRS. Additional rules of limited application were provided by Treasury regulations and, in a few instances, statutory bills. Pre-1986 law was believed to be unclear regarding the character, the timing of recognition, and the source of gain or loss due to fluctuations in the exchange rate of foreign currency. The result of prior law was uncertainty of tax treatment for many legitimate transactions, as well as opportunities for tax-motivated transactions. Therefore, in the 1986 Act, Congress determined that a comprehensive set of rules should be provided for the U.S. tax treatment of transactions involving "nonfunctional currencies;" that is, currencies other than the taxpayer's "functional currency."

However, the 1986 Act provisions designed to clarify the treatment of currency transactions, primarily found in section 988, apply to transactions entered into by an individual only to the extent that expenses attributable to such transactions would be deductible under section 162 (as a trade or business expense) or section 212 (as an expense of producing income, other than expenses incurred in connection with the determination, collection, or refund of taxes). Therefore, the principles of pre-1986 law continue to apply to personal currency transactions.[1]

Description of Proposal

In a case where an individual acquires nonfunctional currency and then disposes of it in a personal transaction, and where exchange rates have changed in the intervening period, the proposal would provide for nonrecognition of an individual's resulting exchange gain provided that such gain does not exceed $200. The bill would not change the treatment of resulting exchange losses. It is understood that under other Code provisions, such losses typically are not deductible by individuals (e.g., sec. 165(c)).

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

4. Treatment of certain reimbursed expenses of rural letter carriers' vehicle

Present Law

A taxpayer who uses his or her automobile for business purposes may deduct the business portion of the actual operation and maintenance expenses of the vehicle, plus depreciation (subject to the limitations of sec. 280F). Alternatively, the taxpayer may elect to utilize a standard mileage rate in computing the deduction allowable for business use of an automobile that has not been fully depreciated. Under this election, the taxpayer's deduction equals the applicable rate multiplied by the number of miles driven for business purposes and is taken in lieu of deductions for depreciation and actual operation and maintenance expenses.

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[1] See, e.g., Rev. Rul. 90-79, 1990-2 C.B. 187 (where the taxpayer purchased a house in a foreign country, financed by a foreign currency loan, and the currency appreciates before the house is sold and the loan is repaid, the taxpayer's exchange loss on repayment of the loan is not deductible under sec. 165 and does not offset taxable gain on the sale of the house).

An employee of the U.S. Postal Service may compute his deduction for business use of an automobile in performing services involving the collection and delivery of mail on a rural route by using, for all business use mileage, 150 percent of the standard mileage rate.

Rural letter carriers are paid an equipment maintenance allowance (EMA) to compensate them for the use of their personal automobiles in delivering the mail. The tax consequences of the EMA are determined by comparing it with the automobile expense deductions that each carrier is allowed to claim (using either the actual expenses method or the 150 percent of the standard mileage rate). If the EMA exceeds the allowable automobile expense deductions, the excess generally is subject to tax. If the EMA falls short of the allowable automobile expense deductions, a deduction is allowed only to the extent that the sum of this shortfall and all other miscellaneous itemized deductions exceeds two percent of the taxpayer's adjusted gross income.

Description of Proposal

The proposal would repeal the special rate for Postal Service employees of 150 percent of the standard mileage rate. In its place, the proposal would provide that the rate of reimbursement provided by the Postal Service to rural letter carriers would be considered to be equivalent to their expenses. The rate of reimbursement that would be considered to be equivalent to their expenses would be the rate of reimbursement contained in the 1991 collective bargaining agreement, which may in the future be increased by no more than the rate of inflation.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

5. Exclusion of combat pay from withholding limited to amount excludable from gross income

Present Law

Exclusion for combat pay

Gross income does not include certain combat pay of members of the Armed Forces (Code sec. 112). If enlisted personnel serve in a combat zone during any part of any month, military pay for that month is excluded from gross income. In addition, if enlisted personnel are hospitalized as a result of injuries, wounds, or disease incurred in a combat zone, military pay for

that month is also excluded from gross income; this exclusion is limited, however, to hospitalization during any month beginning not more than two years after the end of combat in the zone. In the case of commissioned officers, these exclusions from income are limited to $500 per month of military pay.

Income tax withholding

There is no income tax withholding with respect to military pay for a month in which a member of the Armed Forces of the United States is entitled to the benefits of section 112 (sec. 3401(a)(2)). With respect to enlisted personnel, this income tax withholding rule parallels the exclusion from income under section 112: there is total exemption from income tax withholding and total exclusion from income. With respect to officers, however, the withholding rule is not parallel: there is total exemption from income tax withholding, although the exclusion from income is limited to $500 per month.

Description of Proposal

The proposal would make the income tax withholding exemption rules parallel to the rules providing an exclusion from income for combat pay.

Effective Date

The proposal would be effective as of January 1, 1996.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

6. Travel expenses of Federal employees participating in a Federal criminal investigation

Present Law

Unreimbursed ordinary and necessary travel expenses paid or incurred by an individual in connection with temporary employment away from home (e.g., transportation costs and the cost of meals and lodging) are generally deductible, subject to the two-percent floor on miscellaneous itemized deductions. Travel expenses paid or incurred in connection with indefinite employment away from home, however, are not deductible. A taxpayer's employment away from home in a single location is indefinite rather than temporary if it lasts for one year or more; thus, no deduction is permitted for travel expenses paid or incurred in connection with such employment (sec. 162(a)). If a taxpayer's employment away from home in a single location lasts for less than

one year, whether such employment is temporary or indefinite is determined on the basis of the facts and circumstances.

Description of Proposal

The one-year limitation with respect to deductibility of expenses while temporarily away from home would not include any period during which a Federal employee is certified by the Attorney General (or the Attorney General's designee) as travelling on behalf of the Federal Government in a temporary duty status to investigate or provide support services to the investigation of a Federal crime. Thus, expenses for these individuals during these periods would be fully deductible, regardless of the length of the period for which certification is given (provided that the other requirements for deductibility are satisfied).

Effective Date

The proposal would be effective for amounts paid or incurred with respect to taxable years ending after the date of enactment.

II. PENSION SIMPLIFICATION

A. Simplified Distribution Rules

Present Law

In general

Under present law, a distribution of benefits from a tax-favored retirement arrangement generally is includible in gross income in the year it is paid or distributed under the rules relating to the taxation of annuities. A tax-favored retirement arrangement includes (1) a qualified pension plan (sec. 401(a)), (2) a qualified annuity plan (sec. 403(a)), and (3) a tax-sheltered annuity (sec. 403(b)). Special rules apply in the case of lump-sum distributions from a qualified plan, distributions that are rolled over to an individual retirement arrangement ("IRA"), and employer-provided death benefits.

Lump-sum distributions

Under present law, lump-sum distributions from qualified plans and annuities are eligible for special 5-year forward income averaging (sec. 402(d)). In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee that becomes payable to the recipient (1) on account of the death of the employee, (2) after the employee attains age 59-1/2, (3) on account of the employee's separation from service, or (4) in the case of self-employed individuals, on account of disability. Lump-sum treatment is not available for distributions from a tax-sheltered annuity.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59-1/2 to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. In general, this election allows the taxpayer to pay a separate tax on the lump-sum distribution that approximates the tax that would be due if the lump-sum distribution was received in 5 equal installments. If the election is made, the taxpayer is entitled to deduct the amount of the lump-sum distribution from gross income. Only one such election on or after age 59-1/2 may be made with respect to any employee.

Special transition rules adopted in the Tax Reform Act of 1986 are available with respect to an employee who attained age 50 before January 1, 1986. Under these rules, an individual, trust, or estate may elect to use 5-year forward income averaging (using present-law tax rates) or 10-year forward income averaging (using the tax rates in effect prior to the Tax Reform Act of 1986) with regard to a single lump-sum distribution, without regard to whether the employee has attained age 59-1/2. In addition, an individual, trust, or estate receiving a lump-sum distribution with respect to such employee may elect to retain the capital gains character of the pre-1974 portion of the lump-sum distribution (using a tax rate of 20 percent).

Employer-provided death benefits

Under present law, the beneficiary or estate of a deceased employee generally can exclude up to $5,000 in benefits paid by or on behalf of an employer by reason of the employee's death (sec. 101(b)).

Recovery of basis

Qualified plan distributions other than lump-sum distributions generally are includible in gross income in the year they are paid or distributed under the rules relating to taxation of annuities (sec. 402(a)). Amounts received as an annuity generally are includible in income in the year received, except to the extent they represent the return of the recipient's investment in the contract (i.e., basis) (sec. 72(b)). Under present law, a pro-rata basis recovery rule generally applies, so that the portion of any annuity payment that represents nontaxable return of basis is determined by applying an exclusion ratio equal to the employee's total investment in the contract divided by the total expected payments over the term of the annuity.

Under a simplified alternative method provided by the Internal Revenue Service ("IRS") (Notice 88-118) for payments from or under qualified retirement arrangements, the taxable portion of qualifying annuity payments is determined under a simplified exclusion ratio method.

Under both the pro-rata and simplified alternative methods, in no event can the total amount excluded from income as nontaxable return of basis be greater than the recipient's total investment in the contract.

Required distributions

Present law provides uniform minimum distribution rules generally applicable to all types of tax-favored retirement vehicles, including qualified plans and annuities, IRAs, and tax-sheltered annuities.

Under present law, a qualified plan is required to provide that the entire interest of each participant will be distributed beginning no later than the participant's required beginning date (sec. 401(a)(9)). The required beginning date is generally April 1 of the calendar year following the calendar year in which the plan participant or IRA owner attains age 70-1/2. In the case of a governmental plan or a church plan, the required beginning date is the later of (1) such April 1, or (2) the April 1 of the year following the year in which the participant retires.

Description of Proposals

In general

The proposal would sunset 5-year averaging for lump-sum distributions from qualified plans, repeal the $5,000 death benefit exclusion, and simplify the basis recovery rules applicable to distributions from qualified plans. In addition, the proposal would modify the rule that generally requires all participants to commence distributions by age 70-1/2.

Special rules for lump-sum distributions

The proposal would sunset the special 5-year forward income averaging rule. Thus, the proposal would repeal the separate tax paid on a lump-sum distribution and would also repeal the deduction from gross income for taxpayers who elect to pay the separate tax on a lump-sum distribution. The proposal would preserve the transition rules adopted in the Tax Reform Act of 1986.

Employer-provided death benefits

The proposal would repeal the exclusion from gross income of up to $5,000 in employer-provided death benefits.

Recovery of basis

Under the proposal, the portion of an annuity distribution from a qualified retirement plan, qualified annuity, or tax-sheltered annuity that represents nontaxable return of basis generally would be determined under a method similar to the present-law simplified alternative method provided by the IRS. Under the simplified method provided in the proposal, the portion of each annuity payment that represents nontaxable return of basis generally would be equal to the employee's total investment in the contract as of the annuity starting date, divided by the number of anticipated payments determined by reference to the age of the participant in accordance with the table below. The number of anticipated payments listed in the table would be based on the employee's age on the annuity starting date. If the number of payments is fixed under the terms of the annuity, that number would be used instead of the number of anticipated payments listed in the table.

If the age of the primary annuitant on the annuity starting date is:	The number of anticipated payments is:
Not more than 55	300
More than 55 but not more than 60	260
More than 60 but not more than 65	240
More than 65 but not more than 70	170
More than 70	120

The simplified method would not be available if the primary annuitant has attained age 75 on the annuity starting date unless there are fewer than 5 years of guaranteed payments under the annuity. If, in connection with commencement of annuity payments, the recipient receives a lump-sum payment that is not part of the annuity stream, such payment would be taxable under the rules relating to annuities (sec. 72) as if received before the annuity starting date, and the investment in the contract used to calculate the simplified exclusion ratio for the annuity payments would be reduced by the amount of the payment. As under present law, in no event would the total amount excluded from income as nontaxable return of basis be greater than the recipient's total investment in the contract.

Required distributions

The proposal would modify the rule that requires all participants in qualified plans to commence distributions by age 70-1/2 without regard to whether the participant is still employed by the employer and generally would replace it with the rule in effect prior to the Tax Reform Act of 1986. Under the proposal, distributions generally would be required to begin by April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70-1/2 or (2) the calendar year in which the employee retires. However, in the case of a 5-percent owner of the employer, distributions would be required to begin no later than the April 1 of the calendar year following the year in which the 5-percent owner attains age 70-1/2.

In addition, in the case of an employee (other than a 5-percent owner) who retires in a calendar year after attaining age 70-1/2, the proposal generally would require the employee's accrued benefit to be actuarially increased to take into account the period after age 70-1/2 in which the employee was not receiving benefits under the plan. Thus, under the proposal, the employee's accrued benefit would be required to reflect the value of benefits that the employee would have received if the employee had retired at age 70-1/2 and had begun receiving benefits at that time.

The actuarial adjustment rule and the rule requiring 5-percent owners to begin distributions after attainment of age 70-1/2 would not apply, under the proposal, in the case of a

governmental plan or church plan.

Effective Date

The simplified distribution rule proposals generally would apply to years beginning after December 31, 1995. The modifications to the basis recovery rules would apply with respect to annuity starting dates after December 31, 1995. The sunset of 5-year forward averaging would be effective with respect to taxable years beginning after December 31, 1995.

Legislative Background

These proposals were included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

B. Increased Access to Pension Plans

1. Modification of simplified employee pensions (SEPs)

Present Law

Under present law, certain employers (other than tax-exempt and governmental employers) can establish a simplified employee pension ("SEP") for the benefit of their employees under which the employees can elect to have contributions made to the SEP or to receive the contributions in cash (sec. 408(k)(6)). The amounts the employee elects to have contributed to the SEP are not currently includible in income. Elective deferrals under a SEP are to be treated in the same manner as elective deferrals under a qualified cash or deferred arrangement and, thus, are subject to the $9,240 (for 1995) limit on elective deferrals.

The election to have amounts contributed to a SEP or received in cash is available only if at least 50 percent of the employees of the employer elect to have amounts contributed to the SEP. In addition, such election is available for a taxable year only if the employer maintaining the SEP had 25 or fewer eligible employees at all times during the prior taxable year.

Under present law, elective deferrals under SEPs are subject to a special nondiscrimination test. The amount eligible to be deferred as a percentage of each highly compensated employee's compensation (i.e., the deferral percentage) is limited by the average deferral percentage (based solely on elective deferrals) for all nonhighly compensated employees who are eligible to participate. The deferral percentage for each highly compensated employee (taking into account only the first $150,000 (for 1995) of compensation) in any year cannot exceed 125 percent of the average deferral percentage for all other eligible employees for that year. Nonelective SEP contributions may not be combined with the elective SEP deferrals for purposes of this test. An employer may not make any other SEP contributions conditioned on elective SEP deferrals. If the 125-percent test is not satisfied, rules similar to the rules applicable to excess contributions to a cash or deferred arrangement (sec. 401(k)) are applied (see C.4., below).

Description of Proposals

The proposal would modify the rules relating to salary reduction SEPs by providing that such SEPs may be established by employers with 100 or fewer employees. The proposal would also repeal the requirement that at least half of eligible employees actually participate in a salary reduction SEP. The proposal would also modify the special nondiscrimination test applicable to elective deferrals under SEPs so that the maximum permitted actual deferral percentage for highly compensated employees for the year is determined by reference to the actual deferral percentage for nonhighly compensated employees for the preceding, rather than the current, year (see C.4., below). The proposal would permit a salary reduction SEP to satisfy the design-based safe harbor available to qualified cash or deferred arrangements (see C.4., below).

Effective Date

The proposals would apply to years beginning after December 31, 1995.

Legislative Background

The proposals, other than the proposal relating to the timing for calculating the special nondiscrimination test applicable to elective deferrals and the proposal that would permit a salary reduction SEP to satisfy a design-based nondiscrimination safe harbor, were included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

2. Tax-exempt organizations and State and local governments eligible under section 401(k)

Present Law

Under present law, if a tax-qualified profit-sharing or stock bonus plan meets certain requirements, then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash (sec. 401(k)). Plans containing this feature are referred to as cash or deferred arrangements. Tax-exempt and State and local governmental organizations are generally prohibited from establishing qualified cash or deferred arrangements. Because of this limitation, many of such employers are precluded from maintaining broad-based, funded, elective deferral arrangements for their employees.

Description of Proposal

The proposal would allow tax-exempt organizations and State and local governments and their agencies and instrumentalities to maintain cash or deferred arrangements, unless the entity maintains a section 457 plan.. Thus, any organization, including an Indian tribe, previously denied eligibility on the ground that they are a tax-exempt organization or a State or local government or agency or instrumentality thereof would be eligible to maintain a cash or deferred arrangement for its employees under the proposal.

Effective Date

The proposal would be effective with respect to years beginning after December 31, 1996.

Legislative Background

A similar proposal to allow tax-exempt organizations (but not State and local government employers) to maintain cash or deferred arrangements was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

C. Nondiscrimination Provisions

1. Simplified definition of highly compensated employee

Present Law

For purposes of the rules applying to qualified retirement plans under the Code, an employee, including a self-employed individual, generally is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee: (1) was a 5-percent owner of the employer; (2) received more than $100,000 (for 1995) in annual compensation from the employer; (3) received more than $66,000 (for 1995) in annual compensation from the employer and was one of the top-paid 20 percent of employees during the same year; or (4) was an officer of the employer who received compensation greater than $60,000 (for 1995). If, for any year, no officer has compensation in excess of $60,000 (for 1995), then the highest paid officer of the employer for such year is treated as a highly compensated employee. These dollar amounts are adjusted annually for inflation at the same time and in the same manner as the adjustments to the dollar limit on benefits under a defined benefit pension plan (sec. 415(d)).

Description of Proposal

The proposal would provide that an employee is highly compensated with respect to a year if the employee (1) was a 5-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of $80,000. The $80,000 threshold would be adjusted for cost-of-living increases in the same manner and at the same time (using a base-year period beginning October 1, 1995) as the limitations on contributions and benefits (sec. 415(d)). The bill would also repeal the requirement that if, for a plan year, there are no highly compensated employees, the highest paid officer is treated as a highly compensated employee.

Effective Date

The proposal would be effective for years beginning after December 31, 1995.

Legislative Background

A similar proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994, except for the repeal of the one-officer rule.

2. Repeal of family aggregation rules

Present Law

Treatment of family members

A special rule applies with respect to the treatment of family members of certain highly compensated employees for purposes of the nondiscrimination rules applicable to qualified plans. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top-10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution or benefit under the plan on behalf of such family member is aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top-10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee. An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

Similar family aggregation rules apply with respect to the $150,000 (for 1995) limit on compensation that may be taken into account under a qualified plan (sec. 401(a)(17)) and for deduction purposes (sec. 404(l)). However, under such provisions, only the spouse of the employee and lineal descendants of the employee who have not attained age 19 are taken into account.

Description of Proposal

The proposal would repeal the family aggregation rules.

Effective Date

The proposal would be effective for years beginning after December 31, 1995.

Legislative Background

This proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

3. Modification of additional participation requirements

Present Law

Under present law, a plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer or (b) 40 percent of all employees of the employer (sec. 401(a)(26)). This requirement may not be satisfied by aggregating comparable plans, but may be

applied separately to different lines of business of the employer. A line of business of the employer does not qualify as a separate line of business unless it has at least 50 employees.

Description of Proposal

The proposal would provide that the minimum participation rule applies only to defined benefit pension plans. In addition, the proposal would provide that a defined benefit pension plan does not satisfy the rule unless it benefits no fewer than the lesser of (1) 50 employees or (2) the greater of (a) 40 percent of all employees of the employer or (b) 2 employees (1 employee if there is only 1 employee).

The proposal would provide that the requirement that a line of business has at least 50 employees does not apply in determining whether a plan satisfies the minimum participation rule on a separate line of business basis.

Effective Date

The proposal would be effective for years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

4. Nondiscrimination rules for qualified cash or deferred arrangements

Present Law

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. The maximum annual amount of elective deferrals that can be made by an individual is $9,240 for 1995. This dollar limit is indexed for inflation. A special nondiscrimination test applies to cash or deferred arrangements.

The special nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements is satisfied if the actual deferral percentage ("ADP") for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the ADP of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the ADP of all eligible nonhighly compensated employees or such ADP plus 2 percentage points. The ADP for a group of employees is the average of the ratios (calculated

separately for each employee in the group) of the contributions paid to the plan on behalf of the employee to the employee's compensation.

Employer matching contributions and after-tax employee contributions under qualified defined contribution plans are subject to a special nondiscrimination test similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements.

The special nondiscrimination test is satisfied for a plan year if the actual contribution percentage ("ACP") for eligible highly compensated employees does not exceed the greater of (1) 125 percent of the ACP for all other eligible employees, or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The ACP for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

To determine the amount of excess contributions and the employees to whom they are allocated, the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentage beginning with those highly compensated employees with the highest actual deferral percentages.

Description of Proposal

In general

The proposal would modify the present-law nondiscrimination test applicable to elective deferrals and employer matching and after-tax employee contributions to provide that the maximum permitted actual deferral percentage for highly compensated employees for the year is determined by reference to the actual deferral percentage for nonhighly compensated employees for the preceding, rather than the current, year. In the case of the first plan year of a qualified cash or deferred arrangement, the actual deferral percentage of nonhighly compensated employees for the previous year would be deemed to be 3 percent or, at the election of the employer, the actual deferral percentage for such first plan year.

In addition, the proposal would add alternative methods of satisfying the special nondiscrimination requirements applicable to elective deferrals and employer matching contributions. Under these safe harbor rules, a cash or deferred arrangement would be treated as satisfying the actual deferral percentage test if the plan of which the arrangement is a part (or any other plan of the employer maintained with respect to the employees eligible to participate in the cash or deferred arrangement) meets (1) one of two contribution requirements and (2) a notice requirement. A plan would satisfy the safe harbor with respect to matching contributions if (1) the plan meets the contribution and notice requirements under the safe harbor for cash or deferred arrangements and (2) the plan satisfies a special limitation on matching contributions. These safe

harbors would permit a plan to satisfy the special nondiscrimination tests through plan design, rather than through the testing of actual contributions.

The proposal would also modify the method of determining excess contributions under the present-law nondiscrimination test.

Safe harbor for cash or deferred arrangements

A plan would satisfy the contribution requirements under the safe harbor rule for qualified cash or deferred arrangements if the plan either (1) satisfies a matching contribution requirement or (2) the employer makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to whether the employee makes elective contributions under the arrangement.

A plan would satisfy the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective contributions up to 3 percent of compensation and (b) 50 percent of the employee's elective contributions from 3 to 5 percent of compensation; and (2) the level of match for highly compensated employees is not greater than the match rate for nonhighly compensated employees at any level of compensation.

Alternatively, if the matching contribution requirement is not satisfied at some level of employee compensation, the requirement would be deemed to be satisfied if (1) the level of employer matching contributions does not increase as employee elective contributions increase and (2) the aggregate amount of matching contributions with respect to elective contributions up to that level of compensation at least equals the amount of matching contributions that would be made if matching contributions satisfied the percentage requirements. For example, the alternative test would be satisfied if an employer matches 125 percent of an employee's elective contributions up to the first 3 percent of compensation, 25 percent of elective deferrals from 3 to 4 percent of compensation, and provides no match thereafter. This is because the employer match does not increase and the aggregate amount of matching contributions is at least equal to the matching contributions required under the general safe harbor rule.

Employer matching and nonelective contributions used to satisfy the contribution requirements of the safe harbor rules would be required to be nonforfeitable and subject to the restrictions on withdrawals that apply to an employee's elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)(2)(B) and (C)).

The notice requirement would be satisfied if each employee eligible to participate in the arrangement is given written notice, within a reasonable period before any year, of the employee's rights and obligations under the arrangement.

Alternative method of satisfying special nondiscrimination test for matching contributions

The proposal would provide a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions. Under this safe harbor, a plan would be treated as meeting the special nondiscrimination test if (1) the plan meets the contribution and notice requirements applicable under the safe harbor method of satisfying the special nondiscrimination requirement for qualified cash or deferred arrangements, and (2) the plan satisfies a special limitation on matching contributions. After-tax employee contributions are tested separately under the ACP test.

The limitation on matching contributions would be satisfied if (1) the matching contributions on behalf of any employee may not be made with respect to employee contributions or elective deferrals in excess of 6 percent of compensation and (2) the level of an employer's matching contribution does not increase as an employee's contributions or elective deferrals increase.

Simplified employee pensions ("SEPs")

The proposal would modify the present-law nondiscrimination test applicable to salary reduction SEPs to provide that the average of the deferral percentages of all nonhighly compensated employees for the preceding, rather than the current, year is to be used. In addition, the proposal would provide that a salary reduction SEP is permitted to use the safe harbor for qualified cash or deferred arrangements.

Distribution of excess contributions

Under the proposal, the total amount of excess contributions would be determined in the same manner as under present law, but the distribution of excess contributions would be required to be made on the basis of the amount of contribution by, or on behalf of, each highly compensated employee. Thus, under the proposal, excess contributions would be deemed attributable first to those highly compensated employees who have made the greatest dollar amount of elective deferrals under the plan. This modified distribution method would also apply to excess contributions that are treated as distributed to an employee and then contributed by the employee to the plan (recharacterization).

Effective Date

The proposal would be effective for plan years beginning after December 31, 1995.

Legislative Background

The proposals, other than the proposal relating to the timing for calculating the nondiscrimination test applicable to salary reduction SEPs and the proposal permitting salary

reduction SEPs to utilize the safe harbor applicable to qualified cash or deferred arrangements, were included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

D. Miscellaneous Pension Simplification

1. Treatment of leased employees

Present Law

An individual (a leased employee) who performs services for another person (the recipient) may be required to be treated as the recipient's employee for various employee benefit provisions if the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer (sec. 414(n)). The individual is to be treated as the recipient's employee only if the individual has performed services for the recipient on a substantially full-time basis for a year, and the services are of a type historically performed by employees in the recipient's business field.

An individual who otherwise would be treated as a recipient's leased employee will not be treated as such an employee if the individual participates in a safe harbor plan maintained by the leasing organization meeting certain requirements. Each leased employee is to be treated as an employee of the recipient, regardless of the existence of a safe-harbor plan, if more than 20 percent of an employer's nonhighly compensated workforce are leased.

Description of Proposal

The present-law "historically performed" test would be replaced with a new rule defining who must be considered a leased employee. Under the proposal, an individual would not be considered a leased employee unless the individual's services are performed under significant direction or control by the service recipient. As under present law, the determination of whether someone is a leased employee would be made after determining whether the individual is a common-law employee of the service recipient. Thus, an individual who is not a common-law employee of the service recipient could nevertheless be a leased employee of the service recipient. Similarly, the fact that a person is or is not found to perform services under significant direction or control of the recipient for purposes of the employee leasing rules would not be determinative of whether the person is or is not a common-law employee of the recipient.

Whether services are performed by an individual under significant direction or control by the service recipient would depend on the facts and circumstances. Factors that would be relevant in determining whether significant direction or control exists include whether the individual is required to comply with instructions of the service recipient about when, where, and how he or she is to perform the services, whether the services must be performed by a particular person, whether the individual is subject to the supervision of the service recipient, and whether the individual must perform services in the order or sequence set by the service recipient. Factors that would generally not be relevant in determining whether such direction or control exists would

include whether the service recipient has the right to hire or fire the individual and whether the individual works for others.

Under the direction or control test, clerical and similar support staff (e.g., secretaries and nurses in a doctor's office) generally would be considered to be subject to significant direction or control of the service recipient and would be leased employees provided the other requirements of section 414(n) are met. On the other hand, outside professionals who maintain their own businesses (e.g., lawyers and accountants) generally would not be considered to be subject to such direction or control. However, the Secretary would be encouraged to continue efforts to prevent abuses in the leased manager area.

The direction or control test would be intended to prevent employers from engaging in abusive practices. The Secretary would be directed to interpret and apply the leased employee rules in a manner so as to prevent abuses.

Effective Date

The proposal would be effective for years beginning after December 31, 1995, except that the changes would not apply to relationships that have been previously determined by an IRS ruling not to involve leased employees. In applying the leased employee rules to years beginning before the effective date, the Secretary would be directed to use a reasonable interpretation of the statute to apply the leasing rules to prevent abuse.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

2. Plans covering self-employed individuals

Present Law

Prior to the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), different rules applied to retirement plans maintained by incorporated employers and unincorporated employers (such as partnerships and sole proprietors). In general, plans maintained by unincorporated employers were subject to special rules in addition to the other qualification requirements of the Code. Most, but not all, of this disparity was eliminated by TEFRA. Under present law, certain special aggregation rules apply to plans maintained by owner employees of unincorporated businesses that do not apply to other qualified plans (sec. 401(d)(1) and (2)).

Description of Proposal

The proposal would eliminate the special aggregation rules that apply to plans maintained by self-employed individuals that do not apply to other qualified plans.

Effective Date

The proposal would be effective for years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

3. Elimination of special vesting rule for multiemployer plans

Present Law

Under present law, except in the case of multiemployer plans, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under 1 of 2 alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the participant's completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service, 60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service.

In the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions is required to be 100 percent vested no later than upon the participant's completion of 10 years of service. This special rule applies only to employees covered by the plan pursuant to a collective bargaining agreement.

Description of Proposal

The proposal would conform the vesting rules for multiemployer plans to the rules applicable to other qualified plans.

Effective Date

The proposal would be effective for plan years beginning on or after the earlier of (1) the later of January 1, 1996, or the date on which the last of the collective bargaining agreements pursuant to which the plan is maintained terminates, or (2) January 1, 1998, with respect to participants with an hour of service after the effective date.

Legislative Background

This proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

4. Distributions under rural cooperative plans

Present Law

Under present law, a qualified cash or deferred arrangement can permit withdrawals by participants only after the earlier of (1) the participant's separation from service, death, or disability, (2) termination of the arrangement, (3) in the case of a profit-sharing or stock bonus plan, the attainment of age 59-1/2, or (4) in the case of a profit-sharing or stock bonus plan, upon hardship of the participant (sec. 401(k)(2)(B)). In the case of a rural cooperative qualified cash or deferred arrangement, which is part of a money purchase pension plan, withdrawals by participants cannot occur upon attainment of age 59-1/2 or upon hardship.

Description of Proposal

The proposal would provide that a rural cooperative plan that includes a qualified cash or deferred arrangement will not be treated as violating the qualification requirements merely because the plan permits distributions to plan participants after the attainment of age 59-1/2.

Effective Date

The proposal would be effective for distributions after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

5. Treatment of governmental plans under section 415

Present Law

Present law imposes limits on contributions and benefits under qualified plans based on the type of plan (sec. 415). The limits apply to plans maintained by private and public employers. Certain special rules apply to governmental plans.

In the case of a defined contribution plan, the annual additions to the plan with respect to each plan participant are limited to the lesser of (1) 25 percent of compensation, or (2) $30,000 (for 1995). The limit on the annual benefits payable by a defined benefit pension plan is generally the lesser of (1) 100 percent of average compensation for the three years in which it was highest, or (2) $120,000 (for 1995). The dollar limit are increased for inflation. The dollar limit is reduced actuarially if payment of benefits is to begin before the social security retirement age, and increased if benefits are to begin after that age.

For purpose of these limits, present law provides that compensation generally does not include employer contributions to certain employee plans under a salary reduction agreement.

Under special rules for plans maintained by State or local governments, such plans may provide benefits greater than those permitted by the limits on benefits applicable to plans maintained by private employers.

Description of Proposal

The proposal would make the following modifications to the limits on contributions and benefits as applied to governmental plans: (1) compensation would include employer contributions to certain employee plans under a salary reduction arrangement; (2) the 100 percent of compensation limitation would not apply; and (3) the defined benefit pension plan limitation would not apply to certain disability and survivor benefits. The proposal also would permit State and local government employers to maintain excess benefit plans (i.e., plans that provide benefits that cannot be provided under a qualified plan due to the limits on contributions and benefits) without regard to the limits on unfunded deferred compensation arrangements of State and local government employers (sec. 457). Benefits provided by such plans would be subject to the same tax rules applicable to excess plans maintained by private employers (e.g., sec. 83).

Effective Date

The proposal would be effective for years beginning on or after January 1, 1996. Governmental plans would be treated as if in compliance with the requirements of section 415 for years beginning before January 1, 1996.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

6. Uniform retirement age

Present Law

A qualified plan generally must provide that payment of benefits under the plan must begin no later than 60 days after the end of the plan year in which the participant reaches age 65. Also, for purpose of the vesting and benefit accrual rules, normal retirement age generally can be no later than age 65. For purposes of applying the limits on contributions and benefits (sec. 415), social security retirement age is generally used as retirement age. The social security retirement age as used for such purposes is presently age 65, but is scheduled to gradually increase.

Description of Proposal

The proposal would provide that for purposes of the general nondiscrimination rule (sec. 401(a)(4)) the social security retirement age (as defined in sec. 415) is a uniform retirement age and that subsidized early retirement benefits and joint and survivor annuities would not be treated as not being available to employees on the same terms merely because they are based on an employee's social security retirement age (as defined in sec. 415).

Effective Date

The proposal would be effective for years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

7. Uniform penalty provision to apply to certain pension reporting requirements

Present Law

Any person who fails to file an information report with the IRS on or before the prescribed filing date is subject to penalties for each failure. The general penalty structure provides that the amount of the penalty is to vary with the length of time within which the taxpayer corrects the failure, and allows taxpayers to correct a de minimis number of errors and avoid penalties entirely (sec. 6721). A different, flat-amount penalty applies for each failure to provide information reports to the IRS or statements to payees relating to pension payments (sec. 6652(e)).

Description of Proposal

The proposal would incorporate into the general penalty structure the penalties for failure to provide information reports relating to pension payments to the IRS and to recipients. Thus, information reports with respect to pension payments would be treated in a similar fashion to other information reports. The proposal would also modify the penalty for failure to provide the notice required with respect to distributions that are eligible for rollover treatment (sec. 402(b)).

Effective Date

The proposal would apply to returns and statements the due date (determined without regard to extensions) for which is after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

8. Contributions on behalf of disabled employees

Present Law

Under present law, an employer may elect to continue deductible contributions to a defined contribution plan on behalf of an employee who is permanently and totally disabled. For purposes of the limit on annual additions (sec. 415(c)), the compensation of a disabled employee is deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled. Contributions are not permitted on behalf of disabled employees who were officers, owners, or highly compensated before they became disabled.

Description of Proposal

The proposal would provide that the special rule for contributions on behalf of disabled employees is applicable without an employer election and to highly compensated employees if the defined contribution plan provides for the continuation of contributions on behalf of all participants who are permanently and totally disabled.

Effective Date

The proposal would apply to years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

9. Treatment of deferred compensation plans of State and local governments and tax-exempt organizations.

Present Law

Under a general principle of the Federal income tax system, individuals are taxed currently not only on compensation actually received, but also on compensation constructively received during the taxable year. An individual is treated as having constructively received compensation during the current taxable year if the compensation would have been payable during the current taxable year but for the individual's election to defer receipt of the compensation to a later taxable year.

An exception to this rule applies to compensation deferred under an eligible unfunded deferred compensation plan (a sec. 457 plan) of a tax-exempt or State or local governmental employer.

Under a section 457 plan, an employee who elects to defer the receipt of current compensation will be taxed on the amounts deferred when such amounts are paid or made available. The maximum annual deferral under such a plan is the lesser of (1) $7,500 or (2) 33-1/3 percent of compensation (net of the deferral).

In general, amounts deferred under a section 457 plan may not be made available to an employee before the earlier of (1) the calendar year in which the participant attains age 70-1/2, (2) when the participant is separated from service with the employer, or (3) when the participant is faced with an unforeseeable emergency. Amounts that are made available to an employee upon separation from service are includible in gross income in the taxable year in which they are made available.

Under present law, benefits under a section 457 plan are not treated as made available if the participant may elect to receive a lump sum payable after separation from service and within 60 days of the election. This exception to the general rules is available only if the total amount payable to the participant under the plan does not exceed $3,500 and no additional amounts may be deferred under the plan with respect to the participant.

Description of Proposal

The proposal would make three changes to the rules governing unfunded deferred compensation plans of tax-exempt and governmental employers.

First, the proposal would permit in-service distributions of accounts that do not exceed $3,500 if no amount has been deferred under the plan with respect to the account for 2 years and there has been no prior distribution under this cash-out rule.

Second, the proposal would increase the number of elections that can be made with respect to the time distributions must begin under the plan. The proposal would provide that the amount payable to a participant under a section 457 plan is not to be treated as made available merely because the participant may elect to defer commencement of distributions under the plan if (1) the election is made after amounts may be distributed under the plan but before the actual commencement of benefits, and (2) the participant makes only 1 such additional election. This additional election would be permitted without the need for financial hardship, and the election can only be to a date that is after the date originally selected by the participant.

Third, the proposal would provide for indexing of the dollar limit on deferrals.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

10. Require individual ownership of section 457 plan assets

Present Law

Compensation deferred under an eligible unfunded deferred compensation plan (a "sec. 457 plan") of a tax-exempt or State and local governmental employer is not includible in gross income until paid or made available. One of the requirements for a section 457 plan is that the maximum annual amount that can be deferred is the lesser of $7,500 or 33-1/3 percent of the individual's taxable compensation. This maximum limit is coordinated with the annual limit on elective deferrals under qualified cash or deferred arrangements (sec. 401(k) plans) and similar arrangements.

Amounts deferred under a section 457 plan generally may not be made available to an employee before the earlier of (1) the calendar year in which the employee attains age 70-1/2, (2) when the employee is separated from service with the employer, or (3) when the employee is faced with an unforeseeable emergency. Amounts that are made available to an employee upon separation from service are includible in gross income in the taxable year in which they are made available.

Another requirement of a section 457 plan is that (until the compensation is made available to the participant) all amounts of compensation deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights must remain solely the property and rights of the employer, subject only to the claims of the employer's general creditors. Consequently, compensation deferred by employees under a section 457 plan are not protected from the employer's general creditors in case of the employer's bankruptcy. By contrast, the assets of a qualified cash or deferred arrangement must be held in trust for the exclusive benefit of employees and cannot be used by the employer or the employer's creditors.

Amounts deferred under plans of tax-exempt and governmental employers that do not meet the requirements of section 457 are includible in gross income in the first year in which there is no substantial risk of forfeiture of such amounts.

Description of Proposal

Under the proposal, all amounts deferred (including amounts deferred prior to the effective date of the proposal) under a section 457 plan maintained by a State and local governmental employer would have to be held in trust (or custodial account or annuity contract) for the exclusive benefit of employees. Consequently, the requirement that amounts deferred

under a section 457 plan be subject only to the claims of the employer's creditors would be repealed with respect to State and local governmental section 457 plans. The trust would be provided tax-exempt status and, as under present law, amounts would not includible in income until made available to the employee.

All other present-law requirements applicable to section 457 plans, including the annual limit on the maximum amount of deferral and the restrictions on when amounts deferred can be made available, would still apply. Further, to the extent these requirements, including the trust requirement, are not satisfied, amounts deferred would be includible in the employee's income when there is no substantial risk of forfeiture.

The proposal would not modify the present-law rules applicable to section 457 plans of tax-exempt employers other than State and local government employers.

Effective Date

The proposal would be effective on the later of (1) January 1, 1996, or (2) 90 days after the date of enactment. Amounts deferred under a section 457 plan maintained by a State or local government prior to such date would have to be held in trust by such date.

11. Correction of GATT interest and mortality rate provisions in the Retirement Protection Act

Present Law

Present law imposes limits on contributions and benefits under qualified plans based on the type of plan, i.e., based on whether the plan is a defined contribution plan or a defined benefit pension plan (sec. 415). An overall limit applies if an individual is a participant in both a defined benefit pension plan and a defined contribution plan.

In the case of a defined contribution plan, annual additions to the plan with respect to each participant for a limitation year generally cannot exceed the lesser of (1) 25 percent of compensation or (2) $30,000 (for 1995).

The limit on the annual benefits payable by a defined benefit pension plan is generally the lesser of (1) 100 percent of average compensation for the three years in which it was the highest or (2) $120,000 (for 1995). If a benefit is payable under the plan in a form other than a straight life annuity, then the benefit must be actuarially adjusted to an equivalent annual straight life annuity before applying the limit on benefits. In addition, if a benefit is payable beginning at an age other than the participant's social security retirement age, the $120,000 dollar limitation is actuarially adjusted so that it equals an annual benefit that is equivalent to the dollar limitation at the participant's social security retirement age. The limit is reduced if benefits begin before social security retirement age, and increased if benefits begin after social security retirement age.

The Retirement Protection Act of 1994, enacted as part of the implementing legislation for the General Agreement on Tariffs and Trade ("GATT"), modified the actuarial assumptions that must be used in adjusting benefits and limitations. In general, in adjusting a benefit that is payable in a form other than a straight life annuity and in adjusting the dollar limitation if benefits begin before social security retirement age, the interest rate to be used cannot be less than 5 percent or the rate specified in the plan. Under the Retirement Protection Act, if the benefit is payable in a form subject to the requirements of section 417(e)(3),[1] then the interest rate on 30-year Treasury securities is substituted for 5 percent.[2] Also under the Retirement Protection Act, for purposes of adjusting any limit or benefit, the mortality table prescribed by the Secretary must be used.

This provision of the Retirement Protection Act is generally effective as of the first day of the first limitation year beginning in 1995.[3]

The maximum benefit payable under present law may be less than the maximum benefit payable under prior law because the 30-year Treasury rate required to be used to adjust benefits and limits under the Retirement Protection Act is higher than the 5-percent interest rate used under prior law. A plan is permitted, but not required, to reduce benefits as of the last day of the last limitation year beginning before January 1, 1995, below the level that would have been paid under prior law. A plan will not be treated as violating the Code rule prohibiting cutbacks in accrued benefits (sec. 411(d)(6)) merely because it reduces benefits to comply with this provision of the Retirement Protection Act. Thus, a participant's accrued benefit may be reduced if the reduction results solely from the application of this provision.

The Retirement Protection Act made similar changes to the interest rate and mortality assumptions used to calculate the value of lump-sum distributions for purposes of the rule permitting involuntary distributions of certain accrued benefits (sec. 417(e)). In the case of a plan adopted and in effect before December 8, 1995, those provisions do not apply before the earlier of (1) the date a plan amendment applying the new assumptions is adopted or made effective (whichever is later), or (2) the first day of the first plan year beginning after December 31, 1999.

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[1] Benefits subject to these rules include all forms of benefit except nondecreasing annuity benefits payable for the life of the participant or, in the case of a preretirement survivor annuity, the life of the surviving spouse. For this purpose, a nondecreasing annuity includes a qualified joint and survivor annuity, a qualified preretirement survivor annuity, and an annuity that decreases merely because of the cessation or reduction of social security supplements or qualified disability payments. See Rev. Rul. 95-29, 1995-15 I.R.B. 10 (April 10, 1995).

[2] In adjusting the $120,000 limit in the case of benefits that begin after social security retirement age, the interest rate used may not be greater than the lesser of 5 percent or the rate specified in the plan.

[3] An employer may elect to treat the changes as being effective on or after December 8, 1994 (the date of enactment of the Retirement Protection Act).

Description of Proposal

The proposal would conform the effective date of the new interest rate and mortality assumptions that must be used under section 415 to calculate the limits on benefits and contributions to the effective date of the provision relating to the calculation of lump-sum distributions under section 417(e). Under the proposal, a plan would not be required to use the new assumptions in determining the maximum payable benefit under section 415 with respect to benefits accrued before the earlier of (1) the date a plan amendment applying the new assumptions is adopted or made effective (whichever is later), or (2) the first day of the first limitation year beginning after December 31, 1999. This rule would apply only in the case of plans that were adopted and in effect before the date of enactment of the Retirement Protection Act (December 8, 1994).

Until the new assumptions apply, the limit on benefits under section 415 would be calculated under the law in effect immediately prior to the enactment of the Retirement Protection Act, and consistent with plan provisions in effect immediately prior to the enactment of the Retirement Protection Act (provided they are consistent with the law in effect immediately prior to the enactment of the Retirement Protection Act).

To the extent plans have already been amended to reflect the new assumptions, plan sponsors would be permitted within one year of the date of enactment to amend the plan to retroactively reverse such amendment. This rule would apply only in the case of a plan amendment that was adopted or made effective on or before the date of enactment

Effective Date

The proposal would be effective as if included in the Retirement Protection Act.

12. Multiple salary reduction agreements permitted under section 403(b)

Present Law

Under Treasury regulations, a participant in a tax-sheltered annuity plan (sec. 403(b)) is not permitted to enter into more than one salary reduction agreement in any taxable year. These regulations further provide that a salary reduction agreement is effective only with respect to amounts "earned" after the agreement becomes effective, and that a salary reduction agreement must be irrevocable with respect to amounts earned while the agreement is in effect.

These restrictions do not apply to other elective deferral arrangements such as a qualified cash or deferred arrangement (sec. 401(k)). Under Treasury regulations, participants in a qualified cash or deferred arrangement may enter into more than one salary reduction agreement in a taxable year, such an agreement is effective with respect to compensation currently available

to the participant after the agreement becomes effective even though previously "earned," and the agreement may be revoked by the participant.

Description of Proposal

The proposal would provide that for participants in a tax-sheltered annuity plan, the frequency that a salary reduction agreement may be entered into, the compensation to which such agreement applies, and the ability to revoke such agreement shall be determined under the rules applicable to qualified cash or deferred arrangements.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

13. Repeal of combined plan limit (sec. 415(e))

Present Law

In general

Present law provides limits on contributions and benefits under qualified plans based on the type of plan, i.e., based on whether the plan is a defined contribution plan or a defined benefit pension plan (sec. 415). An overall limit applies if an individual is a participant in both a defined benefit pension plan and a defined contribution plan.

Defined contribution plan limit

Under a defined contribution plan, annual additions to the plan with respect to each participant for a limitation year cannot exceed the lesser of (1) 25 percent of compensation or (2) $30,000 (for 1995). Annual additions generally are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The $30,000 limit is indexed for inflation in $5,000 increments.

Defined benefit plan limit

The limit on the annual benefit payable to (or with respect to) a participant by all defined benefit pension plans of the same employer is generally the lesser of (1) 100 percent of average compensation for the three years in which it was the highest, or (2) $120,000 (for 1995). The $120,000 limit is indexed for inflation in $5,000 increments. If a benefit is payable under the plan in a form other than a straight life annuity, then the benefit must be actuarially adjusted to an equivalent annual straight life annuity before applying the limit on benefits. In addition, if a benefit is payable beginning at an age other than the participant's social security retirement age, the $120,000 dollar limitation is actuarially adjusted so that it equals an annual benefit that is

equivalent to the dollar limitation at the participant's social security retirement age. The limit is reduced if benefits begin before social security retirement age, and increased if benefits begin after social security retirement age.

Combined plan limit

An additional limit applies if an employee participates in both a defined benefit pension plan and a defined contribution plan maintained by the same employer (sec. 415(e)). The combined plan limitation is designed to prevent avoidance of the separate plan limits through the creation of different types of plans.

The combined limit is satisfied if the sum of the "defined benefit plan fraction" and the "defined contribution plan fraction" is not greater than 1.0. Although the sum of these fractions may not exceed 1.0, the plan fractions effectively provide an aggregate limit of the lesser of 1.25 (as applied with respect to the dollar limits) or 1.4 (as applied with respect to the percentage limits).

The defined benefit plan fraction is designed to measure the portion of the maximum permitted defined benefit plan limit that the employee actually uses. The numerator is the participant's projected normal retirement benefit determined at the close of the year. The denominator is generally the lesser of 125 percent of the dollar limitation for the year, or 140 percent of the employee's average compensation for the three years of employment in which the employee's average compensation was highest.

The defined contribution plan fraction measures the portion that the employee actually uses of the maximum permitted contributions to a defined contribution plan for the employee's total years of service with the employer. The numerator is generally the total of the contributions and forfeitures allocated to the employee's account for each of the employee's years of service with the employer through the close of the year for which the fraction is being determined. The denominator is the sum of the lesser of the following amounts, computed separately for such year and each prior year of service with the employer: (1) 125 percent of the dollar amount in effect for such year, or (2) 140 percent of the 25 percent of compensation limit for the participant.

Description of Proposal

The proposal would repeal the combined limit for participants in both a defined contribution plan and a defined benefit pension plan maintained by the same employer.

Effective Date

The repeal of the combined plan limit would apply to limitation years beginning after December 31, 1996.

14. Waiver of minimum waiting period for qualified plan distributions

Present Law

Present law contains a number of rules designed to provide income to the surviving spouse of a deceased employee. Under these spousal protection rules, defined benefit pension plans and money purchase pension plans are required to provide that vested retirement benefits with a present value in excess of $3,500 are payable in the form of a qualified joint and survivor annuity ("QJSA") or, in the case of a participant who dies before the annuity starting date, a qualified preretirement survivor annuity ("QPSA").

Benefits from a plan subject to the survivor benefit rules may be paid in a form other than a QJSA or QPSA if the participant waives the QJSA or QPSA (or both) and the applicable notice, election, and spousal consent requirements are satisfied.

Present law contains detailed rules regarding the waiver of the QJSA or QPSA forms of benefit and the spousal consent requirements. Generally an election to waive the QJSA or QPSA forms of benefit must be in writing, and, if the participant is married on the annuity starting date, must be accompanied by a written spousal consent acknowledging the effect of such consent and witnessed by a plan representative or notary public. Both the participant's waiver and the spousal consent must state the specific nonspouse beneficiary who will receive the benefit, and, in the case of a QJSA waiver, must specify the particular optional form of benefit that will be paid. The waiver will not be valid unless the participant has previously received a written explanation of (1) the terms and conditions of the QJSA or QPSA forms of benefit, (2) the participant's right to make, and the effect of, an election to waive these forms of benefits, (3) the rights of the participant's spouse, and (4) the right to make, and the effect of, a revocation of an election to waive these forms of benefits.

Treasury regulations provide that in the case of a QJSA, this written explanation must generally be provided to participants no less than 30 days and no more than 90 days before the annuity starting date. The participant's election to waive the QJSA and the spousal consent must be made no more than 90 days before the annuity starting date. Consequently, even if a participant has elected to waive the QJSA and the spouse has consented to the distribution, the distribution from the plan cannot be made until 30 days after the written explanation was provided to the participant.

Description of Proposal

The proposal would provide that the 30-day minimum period prescribed by the Secretary of the Treasury in regulations between the date the explanation of the QJSA is provided and the annuity starting date shall not apply if waived by the participant and, if applicable, the participant's spouse. For example, if the participant has not elected to waive the QJSA, only the participant need waive the 30-day minimum waiting period.

Effective Date

The proposal would be effective with respect to plan years beginning after December 31, 1995.

15. Date for adoption of plan amendments

Present Law

Under regulations, plan amendments to reflect amendments to the Code generally must be made within the remedial amendment period. Such period generally ends at the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs. The plan must be operated in accordance with the law at all times, and any plan amendment must apply retroactively to the period following the effective date of the change which it reflects.

Description of Proposal

The proposal would provide that any plan amendments required by the proposal would not be required to be made before the first plan year beginning on or after January 1, 1997, if (1) the plan is operated in accordance with the applicable provision, (2) the plan is amended to comply with the required changes no later than the first day of the first plan year beginning after December 31, 1996, and (3) the amendment is retroactive to the effective date of the applicable provision.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

III. PARTNERSHIP SIMPLIFICATION PROVISIONS

A. General Provisions

1. Simplified flow-through for large partnerships

Present Law

Treatment of partnerships in general

A partnership generally is treated as a conduit for Federal income tax purposes. Each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction or credit. The character of an item is the same as if it had been directly realized or incurred by the partner. Limitations affecting the computation of taxable income generally apply at the partner level.

The taxable income of a partnership is computed in the same manner as that of an individual, except that no deduction is permitted for personal exemptions, foreign taxes, charitable contributions, net operating losses, certain itemized deductions, or depletion. Elections affecting the computation of taxable income derived from a partnership are made by the partnership, except for certain elections such as those relating to discharge of indebtedness income and the foreign tax credit.

A partnership terminates if either (1) all partners cease carrying on the business, financial operation or venture of the partnership, or (2) within a 12-month period 50 percent or more of the total partnership interests are sold or exchanged.

Description of Proposals

In general

The proposal would modify the tax treatment of a large partnership (generally, a partnership with at least 250 partners, or an electing partnership with at least 100 partners) and its partners. The proposal would provide that each partner takes into account separately the partner's distributive share of the following items, which are determined at the partnership level: (1) taxable income or loss from passive loss limitation activities; (2) taxable income or loss from other activities (e.g., portfolio income or loss); (3) net capital gain or loss to the extent allocable to passive loss limitation activities and other activities; (4) tax-exempt interest; (5) net alternative minimum tax adjustment separately computed for passive loss limitation activities and other activities; (6) general credits; (7) low-income housing credit; (8) rehabilitation credit; (9) credit for producing fuel from a nonconventional source; (10) creditable foreign taxes and foreign source items; and (11) any other items to the extent that the Secretary determines that separate

treatment of such items is appropriate.[1] Separate treatment may be appropriate, for example, should changes in the law necessitate such treatment for any items.

Under the proposal, the taxable income of a large partnership would be computed in the same manner as that of an individual, except that the items described above would be separately stated and certain modifications would be made. These modifications would include disallowing the deduction for personal exemptions, the net operating loss deduction and certain itemized deductions.[2] All limitations and other provisions affecting the computation of taxable income or any credit (except for the at risk, passive loss and itemized deduction limitations, and any other provision specified in regulations) would be applied at the partnership (and not the partner) level. All elections affecting the computation of taxable income or any credit generally would be made by the partnership.

The proposal would provide that a large partnership would not terminate for tax purposes solely because 50 percent of its interests are sold or exchanged within a 12-month period.

Definition of large partnership

A "large partnership" would be any partnership with at least 250 partners in any preceding taxable year that begins after December 31, 1995.[3] Any partnership treated as a large partnership for a taxable year would be so treated for all succeeding years, even if the number of partners falls below 250. Regulations could provide, however, that if the number of partners in any taxable year falls below 100, the partnership would not be treated as a large partnership. Partnerships with at least 100 partners could elect to be treated as large partnerships. The election would apply to the year for which made and all subsequent years and could not be revoked without the Secretary's consent.

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[1] In determining the amounts required to be separately taken into account by a partner, those provisions of the large partnership rules governing computations of taxable income would be applied separately with respect to that partner by taking into account that partner's distributive share of the partnership's items of income, gain, loss, deduction or credit. This rule permits partnerships to make otherwise valid special allocations of partnership items to partners.

[2] A large partnership would be allowed a deduction under section 212 for expenses incurred for the production of income, subject to 70-percent disallowance. No income from a large partnership would be treated as fishing or farming income.

[3] The number of partners would be determined by counting only persons directly holding partnership interests in the taxable year, including persons holding through nominees; persons holding indirectly (e.g., through another partnership) would not be counted. It would not be necessary for a partnership to have 250 or more partners at any one time in a taxable year for the partnership to constitute a large partnership.

A large partnership would not include any partnership if substantially all the partners are: (1) individuals performing substantial services in connection with the partnership's activities, or personal service corporations the owner-employees of which perform such services; (2) retired partners who had performed such services; or (3) spouses of partners who had performed such services. In addition, the term "partner" would not include any individual performing substantial services in connection with the partnership's activities and holding a partnership interest, or an individual who formerly performed such services and who held a partnership interest at the time the individual performed such services.

Other special rules

The large partnership rules would not apply to any partnership the principal activity of which is the buying and selling of commodities (not described in sec. 1221(1)), or options, futures or forwards with respect to commodities.

In general, a large partnership that otherwise meets the qualifications for simplified reporting would not be required to report information to its partners under the rules of that regime if it is substantially engaged in oil and gas related activities. Rather, such a partnership would continue to report information to its partners as under present law. The proposal would permit such a partnership, however, to elect to utilize the simplified reporting regime, as modified for oil and gas purposes. The proposal would provide special rules for large partnerships with oil and gas activities that operate under the simplified reporting regime (i.e., either (1) large partnerships that are substantially engaged in oil and gas activities and which elect to use the regime, or (2) large partnerships that are not substantially engaged in oil and gas operations, but do have some oil and gas activities).

A partnership would be considered to be substantially engaged in oil and gas activities if at least 25 percent of the average value of its assets during the taxable year consists of oil or gas properties.[4] In making this determination, a partnership would be treated as owning its proportionate share of assets of any partnership in which it holds an interest.

Effective Date

The proposals generally would apply to partnership taxable years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.), and H.R. 11 (102nd Cong.), as

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[4] For this purpose, "oil or gas properties" would mean the mineral interests in oil or gas which are of a character with respect to which a deduction for depletion is allowable under section 611.

passed by the House and the Senate in 1992 and vetoed by President Bush.

2. Simplified audit procedures for large partnerships

Present Law

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") established unified audit rules applicable to all but certain small (10 or fewer partners) partnerships. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

Under the TEFRA rules, a partner must report all partnership items consistently with the partnership return or must notify the IRS of any inconsistency. If a partner fails to report any partnership item consistently with the partnership return, the IRS may make a computational adjustment and immediately assess any additional tax that results.

The TEFRA rules establish the "tax matters partner" as the primary representative of a partnership in dealings with the IRS. The tax matters partner is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no tax matters partner is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the tax matters partner.

The IRS generally is required to give notice of the beginning of partnership-level administrative proceedings and any resulting administrative adjustment to all partners whose names and addresses are furnished to the IRS. After the IRS makes an administrative adjustment, the tax matters partner (and, in limited circumstances, certain other partners) may file a petition for readjustment of partnership items in the Tax Court, the district court in which the partnership's principal place of business is located, or the Claims Court.

Description of Proposals

The proposal would create a new audit system for large partnerships. The proposal would define "large partnership" the same way for audit and reporting purposes (generally partnerships with at least 250 partners) except that certain oil and gas partnerships exempted from the large partnership reporting requirements are large partnerships for the audit rules.

Partnership adjustments generally would flow through to the partners for the year in which the adjustment takes effect. Thus, the current-year partners' share of current-year partnership items of income, gains, losses, deductions, or credits would be adjusted to reflect partnership adjustments that take effect in that year. The adjustments generally would not affect prior-year returns of any partners (except in the case of changes to any partner's distributive shares).

In lieu of flowing an adjustment through to its partners, the partnership could elect to pay an imputed underpayment. The imputed underpayment generally would be calculated by netting the adjustments to the income and loss items of the partnership and multiplying that amount by the highest tax rate (whether individual or corporate). A partner could not file a claim for credit or refund of his allocable share of the payment. A partnership could make this election only if it meets requirements set forth in Treasury regulations to assure payment (for example, in the case of a foreign partnership).

The partnership, rather than the partners individually, generally would be liable for any interest and penalties that result from a partnership adjustment. Interest would be computed for the period beginning on the return due date for the adjusted year and ending on the earlier of the return due date for the partnership taxable year in which the adjustment takes effect or the date the partnership pays the imputed underpayment.

Effective Date

The proposal would apply to partnership taxable years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.), and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

3. Advance due date for furnishing information to partners

Present Law

A partnership required to file an income tax return with the Internal Revenue Service must also furnish an information return to each of its partners on or before the day on which the income tax return for the year is required to be filed, including extensions. Under regulations, a partnership must file its income tax return on or before the fifteenth day of the fourth month following the end of the partnership's taxable year (on or before April 15, for calendar year partnerships). This is the same deadline by which most individual partners must file their tax returns.

Description of Proposal

The proposal would provide that a large partnership must furnish information returns to partners by the first March 15 following the close of the partnership's taxable year. Large partnerships would be only those partnerships subject to the simplified reporting rules for large

partnerships (generally, those with at least 250 partners, or electing partnerships with at least 100 partners).

The proposal also would provide that, if the partnership is required to provide copies of the information returns to the Internal Revenue Service on magnetic media, each schedule (such as each Schedule K-1) with respect to each partner would be treated as a separate information return with respect to the corrective periods and penalties that are generally applicable to all information returns.

Effective Date

The proposal would be effective for partnership taxable years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.), and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

4. Partnership returns on magnetic media

Present Law

Partnerships are permitted, but not required, to provide the tax return of the partnership (Form 1065), as well as copies of the schedules sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media.

Description of Proposal

Partnerships would be required to provide the tax return of the partnership (Form 1065), as well as copies of the schedule sent to each partner (Form K-1), to the Internal Revenue Service on magnetic media. An exception would be provided for partnerships with 100 or fewer partners.

Effective Date

The proposal would be effective for partnership taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. A similar proposal also was included in H.R. 4210 (102nd Cong.), and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

5. IRA filing requirements for income from certain unrelated trades and businesses

Present Law

Return filing requirements

An individual retirement account ("IRA") is a trust which generally is exempt from taxation except for the taxes imposed on income from an unrelated trade or business. A fiduciary of a trust that is exempt from taxation (but subject to the taxes imposed on income from an unrelated trade or business) generally is required to file a return on behalf of the trust for a taxable year if the trust has gross income of $1,000 or more included in computing unrelated business taxable income for that year.

Unrelated business taxable income is the gross income (including gross income from a partnership) derived by an exempt organization from an unrelated trade or business, less certain deductions which are directly connected with the carrying on of such trade or business. In calculating unrelated business taxable income, exempt organizations (including IRAs) generally also are permitted a specific deduction of $1,000.

Unified audits of partnerships

All but certain small partnerships are subject to unified audit rules established by the Tax Equity and Fiscal Responsibility Act of 1982. These rules require the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, including such items as gross income and deductions of the partnership.

Description of Proposal

The proposal would modify the filing threshold for an IRA with an interest in a partnership that is subject to the partnership-level audit rules. A fiduciary of such an IRA could treat the trust's share of partnership taxable income as gross income, for purposes of determining whether the trust meets the $1,000 gross income filing threshold. A fiduciary of an IRA that receives taxable income from a partnership that is subject to partnership-level audit rules of less than $1,000 (before the $1,000 specific deduction) would not be required to file an income tax return if the IRA does not have any other income from an unrelated trade or business.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

B. Other Partnership Audit Rules

1. Clarify the treatment of partnership items in deficiency proceedings

Present Law

Partnership proceedings under rules enacted in TEFRA[5] must be kept separate from deficiency proceedings involving the partners in their individual capacities. Prior to the Tax Court's opinion in Munro v. Commissioner, 92 T.C. 71 (1989), the IRS computed deficiencies by assuming that all items that were subject to the TEFRA partnership procedures were correctly reported on the taxpayer's return. However, where the losses claimed from TEFRA partnerships were so large that they offset any proposed adjustments to nonpartnership items, no deficiency could arise from a non-TEFRA proceeding, and if the partnership losses were subsequently disallowed in a partnership proceeding, the non-TEFRA adjustments might be uncollectible because of the expiration of the statute of limitations with respect to nonpartnership items.

Faced with this situation in Munro, the IRS issued a notice of deficiency to the taxpayer that presumptively disallowed the taxpayer's TEFRA partnership losses for computational purposes only. Although the Tax Court ruled that a deficiency existed and that the court had jurisdiction to hear the case, the court disapproved of the methodology used by the IRS to compute the deficiency. Specifically, the court held that partnership items (whether income, loss, deduction, or credit) included on a taxpayer's return must be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items.

Description of Proposal

The proposal would overrule Munro and allow the IRS to return to its prior practice of computing deficiencies by assuming that all TEFRA items whose treatment has not been finally determined had been correctly reported on the taxpayer's return. This would eliminate the need to do special computations that involve the removal of TEFRA items from a taxpayer's return, and will restore to taxpayers a prepayment forum with respect to the TEFRA items. In addition, the proposal would provide a special rule to address the factual situation presented in Munro.

Specifically, the proposal would provide a declaratory judgment procedure in the Tax Court for adjustments to an oversheltered return. An oversheltered return is a return that shows no taxable income and a net loss from TEFRA partnerships. In such a case, the IRS would be authorized to issue a notice of adjustment with respect to non-TEFRA items, notwithstanding that no deficiency would result from the adjustment. However, the IRS could only issue such a notice if a deficiency would have arisen in the absence of the net loss from TEFRA partnerships.

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[5] Tax Equity and Fiscal Responsibility Act of 1982.

The Tax Court would be granted jurisdiction to determine the correctness of such an adjustment as well as to make a declaration with respect to any other item for the taxable year to which the notice of adjustment relates, except for partnership items and affected items which require partner-level determinations. No tax would be due upon such a determination, but a decision of the Tax Court would be treated as a final decision, permitting an appeal of the decision by either the taxpayer or the IRS. An adjustment determined to be correct would thus have the effect of increasing the taxable income that would be deemed to have been reported on the taxpayer's return. If the taxpayer's partnership items were then adjusted in a subsequent proceeding, the IRS would have preserved its ability to collect tax on any increased deficiency attributable to the nonpartnership items.

Alternatively, if the taxpayer chooses not to contest the notice of adjustment within the 90-day period, the bill would provide that when the taxpayer's partnership items are finally determined, the taxpayer has the right to file a refund claim for tax attributable to the items adjusted by the earlier notice of adjustment for the taxable year. Although a refund claim is not generally permitted with respect to a deficiency arising from a TEFRA proceeding, such a rule would be appropriate with respect to a defaulted notice of adjustment because taxpayers may not challenge such a notice when issued since it does not require the payment of additional tax.

In addition, the proposal would incorporate a number of provisions intended to clarify the coordination between TEFRA audit proceedings and individual deficiency proceedings. Under these provisions, any adjustment with respect to a non-partnership item that caused an increase in tax liability with respect to a partnership item would be treated as a computational adjustment and assessed after the conclusion of the TEFRA proceeding. Accordingly, deficiency procedures would not apply with respect to this increase in tax liability, and the statute of limitations applicable to TEFRA proceedings would be controlling.

Effective Date

The proposal would be effective for partnership taxable years ending after the date of enactment.

2. Permit the IRS to rely on partnership returns to determine the proper audit procedures

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Description of Proposal

The proposal would permit the IRS to apply the TEFRA audit procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply. Similarly, the proposal would permit the IRS to apply the normal deficiency procedures if, based on the partnership's return for the year, the IRS reasonably determines that those procedures should apply.

Effective Date

The proposal would be effective for partnership taxable years ending after the date of enactment.

3. Statute of limitations

a. Suspend statute when an untimely petition is filed

Present Law

In a deficiency case, section 6503(a) provides that if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations on assessment and collection is suspended until the decision of the Tax Court becomes final, and for 60 days thereafter. The counterpart to this provision with respect to TEFRA cases is contained in section 6229(d). That section provides that the period of limitations is suspended for the period during which an action may be brought under section 6226 and, if an action is brought during such period, until the decision of the court becomes final, and for 1 year thereafter. As a result of this difference in language, the running of the statute of limitations in a TEFRA case will only be tolled by the filing of a timely petition whereas in a deficiency case, the statute of limitations is tolled by the filing of any petition, regardless of whether the petition is timely.

Description of Proposal

The proposal would conform the suspension rule for the filing of petitions in TEFRA cases with the rule under section 6503(a) pertaining to deficiency cases. Under the proposal, the statute of limitations in TEFRA cases would be suspended by the filing of any petition under section 6226, regardless of whether the petition is timely or valid, and the suspension will remain in effect until the decision of the court becomes final, and for one year thereafter. Hence, if the statute of limitations is open at the time that an untimely petition is filed, the limitations period would no longer continue to run and possibly expire while the action is pending before the court.

Effective Date

The proposal would be effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment.

b. Suspend statute of limitations during bankruptcy proceedings

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(h) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations periods provided in sections 6501 and 6502.

Under present law, because the suspension provision in section 6503(h) applies only to the limitations periods provided in section 6501 and 6502, some uncertainty exists as to whether section 6503(h) applies to suspend the limitations period pertaining to converted items provided in section 6229(f) when a petition naming a partner as a debtor in a bankruptcy proceeding is filed. As a result, the limitations period provided in section 6229(f) may continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the IRS is prohibited from making an assessment against the debtor because of the automatic stay provisions of the Bankruptcy Code.

Description of Proposal

The proposal would clarify that the statute of limitations is suspended for a partner who is named in a bankruptcy petition. The suspension period would be for the entire period during which the IRS is prohibited by reason of the bankruptcy proceeding from making an assessment, and for 60 days thereafter. The provision would not purport to create any inference as to the proper interpretation of present law.

Effective Date

The proposal would be effective with respect to all cases in which the period of limitations has not expired under present law as of the date of enactment.

c. Extend statute of limitations for bankrupt TMPs

Present Law

Section 6229(b)(1)(B) provides that the statute of limitations is extended with respect to all partners in the partnership by an agreement entered into between the tax matters partner (TMP) and the IRS. However, Temp. Treas. Reg. secs. 301.6231(a)(7)-1T(1)(4) and 301.6231(c)-7T(a) provide that upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding, that partner's partnership items convert to nonpartnership items, and if the debtor was the tax matters partner, such status terminates. These rules are necessary because of the automatic stay provision contained in 11 U.S.C. sec. 362(a)(8). As a result, if a consent to extend the statute of limitations is signed by a person who would be the TMP but for the fact that at the time that the agreement is executed the person was a debtor in a bankruptcy proceeding, the consent would not be binding on the other partners because the person signing the agreement was no longer the TMP at the time that the agreement was executed.

Description of Proposal

The proposal would provide that unless the IRS is notified of a bankruptcy proceeding in accordance with regulations, the IRS can rely on a statute extension signed by a person who would be the tax matters partner but for the fact that said person was in bankruptcy at the time that the person signed the agreement. Statute extensions granted by a bankrupt TMP in these cases would be binding on all of the partners in the partnership. The proposal would not purport to create any inference as to the proper interpretation of present law.

Effective Date

The proposal would be effective for extension agreements entered into after the date of enactment.

4. Expand small partnership exception from TEFRA

Present Law

TEFRA established unified audit rules applicable to all partnerships, except for partnerships with 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and for which each partner's share of each partnership item is the same as that partner's share of every other partnership item. Partners in the exempted partnerships are subject to regular deficiency procedures.

Description of Proposal

The proposal would permit a small partnership to have a C corporation as a partner or to specially allocate items without jeopardizing its exception from the TEFRA rules. However, the proposal would retain the prohibition of present law against having a flow-through entity (other than an estate of a deceased partner) as a partner for purposes of qualifying for the small partnership exception.

Effective Date

The proposal would be effective for partnership taxable years ending after the date of enactment.

5. Exclude partial settlements from 1-year assessment rule

Present Law

The period for assessing tax with respect to partnership items generally is the longer of the periods provided by section 6229 or section 6501. For partnership items that convert to nonpartnership items, section 6229(f) provides that the period for assessing tax shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year become nonpartnership items as of the date the partner enters into a settlement agreement with the IRS with respect to such items.

Description of Proposal

The proposal would provide that if a partner and the IRS enter into a settlement agreement with respect to some but not all of the partnership items in dispute for a partnership taxable year and other partnership items remain in dispute, the period for assessing any tax attributable to the settled items would be determined as if such agreement had not been entered into. Consequently, the limitations period that is applicable to the last item to be resolved for the partnership taxable year would be controlling with respect to all disputed partnership items for the partnership taxable year. The proposal would not purport to create any inference as to the proper interpretation of present law.

Effective Date

The proposal would be effective for settlements entered into after the date of enactment.

6. Extend time for filing a request for administrative adjustment

Present Law

If an agreement extending the statute is entered into with respect to a non-TEFRA statute of limitations, that agreement also extends the statute of limitations for filing refund claims (sec. 6511(c)). There is no comparable provision for extending the time for filing refund claims with respect to partnership items subject to the TEFRA partnership rules.

Description of Proposal

The proposal would provide that if a TEFRA statute extension agreement is entered into, that agreement also would extend the statute of limitations for filing refund claims attributable to partnership items or affected items until 6 months after the expiration of the limitations period for assessments.

Effective Date

The proposal would be effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

7. Provide innocent spouse relief for TEFRA proceedings

Present Law

In general, an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met (sec. 6013(e)). However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership.

Description of Proposal

The proposal would provide both a prepayment forum and a refund forum for raising the innocent spouse defense in TEFRA cases.

With respect to a prepayment forum, the proposal would provide that within 60 days of the date that a notice of computational adjustment relating to partnership items is mailed to the spouse of a partner, the spouse could request that the assessment be abated. Upon receipt of such a request, the assessment would be abated and any reassessment will be subject to the deficiency procedures. If an abatement is requested, the statute of limitations would not expire before the date which is 60 days after the date of the abatement. If the spouse files a petition with the Tax Court, the Tax Court would only have jurisdiction to determine whether the requirements of

section 6013(e) have been satisfied. In making this determination, the treatment of the partnership items that gave rise to the liability in question would be conclusive.

Alternatively, the proposal would provide that the spouse of a partner could file a claim for refund to raise the innocent spouse defense. The claim would have to be filed within 6 months from the date that the notice of computational adjustment is mailed to the spouse. If the claim is not allowed the spouse could file a refund action. For purposes of any claim or suit under this provision, the treatment of the partnership items that gave rise to the liability in question would be conclusive.

Effective Date

The proposal, would be effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

8. Determine penalties at the partnership level

Present Law

Partnership items include only items that are required to be taken into account under the income tax subtitle. Penalties are not partnership items since they are contained in the procedure and administration subtitle. As a result, penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding.

Description of Proposal

The proposal would provide that the partnership-level proceeding is to include a determination of the applicability of penalties at the partnership level. However, the proposal would allow partners to raise any partner-level defenses in a refund forum.

Effective Date

The proposal would be effective for partnership taxable years ending after the date of enactment.

9. Clarify jurisdiction of the Tax Court

Present Law

Improper assessment and collection activities by the IRS during the 150-day period for filing a petition or during the pendency of any Tax Court proceeding, "may be enjoined in the proper court." Present law may be unclear as to whether this includes the Tax Court.

For a partner other than the Tax Matters Partner to be eligible to file a petition for redetermination of partnership items in any court or to participate in an existing case, the period for assessing any tax attributable to the partnership items of that partner must not have expired. Since such a partner would only be treated as a party to the action if the statute of limitations with respect to them was still open, the law is unclear whether the partner would have standing to assert that the statute of limitations had expired with respect to them.

Description of Proposal

The proposal would clarify that an action to enjoin premature assessments of deficiencies attributable to partnership items may be brought in the Tax Court. The proposal also would permit a partner to participate in an action or file a petition for the sole purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired for that person. Additionally, the proposal would clarify that the Tax Court has overpayment jurisdiction with respect to affected items.

Effective Date

The proposal would be effective for partnership taxable years ending after the date of enactment.

10. Treatment of premature petitions filed by certain partners

Present Law

The Tax Matters Partner is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of a final partnership administrative adjustment (FPAA). If the Tax Matters Partner does not file a petition within the 90-day period, certain other partners are permitted to file a petition within the 60-day period after the close of the 90-day period. There are ordering rules for determining which action goes forward and for dismissing other actions.

Description of Proposal

The proposal would treat premature petitions filed by certain partners within the 90-day period as being filed on the last day of the following 60-day period under specified circumstances, thus affording the partnership with an opportunity for judicial review that is not available under present law.

Effective Date

The proposal would be effective with respect to petitions filed after the date of enactment.

11. Clarify bond requirement for appeals from TEFRA proceedings

Present Law

A bond must be filed to stay the collection of deficiencies pending the appeal of the Tax Court's decision in a TEFRA proceeding. The amount of the bond must be based on the court's estimate of the aggregate deficiencies of the partners.

Description of Proposal

The proposal would clarify that the amount of the bond should be based on the Tax Court's estimate of the aggregate liability of the parties to the action (and not all of the partners in the partnership). For purposes of this proposal, the amount of the bond could be estimated by applying the highest individual rate to the total adjustments determined by the Tax Court and doubling that amount to take into account interest and penalties.

Effective Date

The proposal would be effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

12. Suspend interest where there is a delay in computational adjustment resulting from TEFRA settlements

Present Law

Interest on a deficiency generally is suspended when a taxpayer executes a settlement agreement with the IRS and waives the restrictions on assessments and collections, and the IRS does not issue a notice and demand for payment of such deficiency within 30 days. Interest on a deficiency that results from an adjustment of partnership items in TEFRA proceedings, however, is not suspended.

Description of Proposal

The proposal would suspend interest where there is a delay in making a computational adjustment relating to a TEFRA settlement.

Effective Date

The proposal would be effective with respect to adjustments relating to taxable years beginning after the date of enactment.

13. Extend time for filing a request for administrative adjustment relating to worthless securities and bad debt

Present Law

The non-TEFRA statute of limitations for filing a claim for credit or refund generally is the later of (1) three years from the date the return in question was filed or (2) two years from the date the claimed tax was paid, whichever is later (sec. 6511(b)). However, an extended period of time, seven years from the date the return was due, is provided for filing a claim for refund of an overpayment resulting from a deduction for a worthless security or bad debt (sec. 6511(d)).

Under the TEFRA partnership rules, a request for administrative adjustment ("RAA") must be filed within three years after the later of (1) the date the partnership return was filed or (2) the due date of the partnership return (determined without regard to extensions) (sec. 6227(a)(1)). In addition, the request must be filed before a final partnership administrative adjustment ("FPAA") is mailed for the taxable year (sec. 6227(a)(2)). There is no special provision for extending the time for filing an RAA that relates to a deduction for a worthless security or an entirely worthless bad debt.

Description of Proposal

The proposal would extend the time for the filing of an RAA relating to the deduction by a partnership for a worthless security or bad debt. In these circumstances, in lieu of the three-year period provided in sec. 6227(a)(1), the period for filing an RAA would be seven years from the date the partnership return was due with respect to which the request is made (determined without regard to extensions). The RAA would still be required to be filed before the FPAA is mailed for the taxable year.

Effective Date

The proposal would be effective as if included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

Legislative Background of Other Partnership Audit Rules

The proposals were included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposals also were included in H.R. 4210 (102nd Cong.), and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

IV. FOREIGN TAX SIMPLIFICATION

A. Modification of Passive Foreign Investment Company Provisions to Eliminate Overlap with Subpart F and to Allow Mark-To-Market Election

Present Law

Overview

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") are taxed currently by the United States on their worldwide income, subject to a credit against U.S. tax on foreign income based on foreign income taxes paid with respect to such income. A foreign corporation generally is not subject to U.S. tax on its income from operations outside the United States.[1]

Income of a foreign corporation generally is taxed by the United States when it is repatriated to the United States through payment to the corporation's U.S. stockholders, subject to a foreign tax credit. However, a variety of regimes imposing current U.S. tax on income earned through a foreign corporation have been reflected in the Code. Today the principal anti-deferral regimes set forth in the Code are the controlled foreign corporation rules of subpart F (secs. 951-964) and the passive foreign investment company rules (secs. 1291-1297). The operation and application of these two regimes are described below. Additional anti-deferral regimes set forth in the Code are the foreign personal holding company rules (secs. 551-558); the personal holding company rules (secs. 541-547); the accumulated earnings tax (secs. 531-537); and the foreign investment company and electing foreign investment company rules (secs. 1246-1247). The anti-deferral regimes included in the Code overlap such that a given taxpayer may be subject to multiple sets of anti-deferral rules.

Controlled foreign corporations

A controlled foreign corporation (CFC) is defined in the Code generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957). Stock ownership includes not only stock owned directly, but also all stock owned indirectly or constructively (sec. 958).

Certain income of a CFC (sometimes referred to as "subpart F income") is subject to current U.S. tax under the Code's subpart F provisions. When a CFC earns subpart F income, the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their pro rata share of the subpart F income. In effect, the Code treats those U.S. shareholders as having

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[1] To the extent that a foreign corporation operates in the United States rather than in foreign countries, it generally pays U.S. tax like a U.S. corporation.

received a current distribution out of the subpart F income. The foreign tax credit may reduce the U.S. tax on such amounts.

Subpart F income typically is income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax. Subpart F income consists of foreign base company income (as defined in sec. 954), insurance income (as defined in sec. 953), and certain income relating to international boycotts and other violations of public policy (as defined in sec. 952(a)(3)-(5)). Subpart F income does not include the foreign corporation's income that is effectively connected with the conduct of a trade or business within the United States, which income is subject to current tax in the United States (sec. 952(b)).

Foreign base company income

Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (sec. 954(a)). In computing foreign base company income, amounts of income in these five categories are reduced by allowable deductions (including taxes and interest) properly allocable to such amounts of income (sec. 954(b)(5)).

One category of foreign base company income is foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally includes interest, dividends, and annuities; some rents and royalties; related party factoring income; net commodities gains; net foreign currency gains; and net gains from sales or exchanges of certain other property.

Foreign personal holding company income under subpart F does not include certain dividends and interest received from a related corporation organized and operating in the same foreign country as the recipient, and certain rents and royalties received from a related corporation for the use of property within the country in which the recipient was created or organized (sec. 954(c)(3)). However, interest, rent, and royalty payments do not qualify for the exclusion to the extent that such payments reduce subpart F income of the payor. In addition, the exclusion does not apply to any dividends with respect to stock owned by a CFC to the extent that the distributed earnings and profits were accumulated by the distributing corporation during periods when the CFC did not hold the stock.

In addition to foreign personal holding company income, foreign base company income includes foreign base company sales and services income, which consist respectively of income attributable to related party purchases and sales routed through the income recipient's country if that country is neither the origin nor the destination of the goods, and income from services performed outside the country of the corporation's incorporation for or on behalf of related persons. Foreign base company income also includes foreign base company shipping income.

Finally, foreign base company income generally includes "downstream" oil-related income (i.e., foreign oil-related income other than extraction income).

Current inclusion of subpart F income

When a CFC earns subpart F income, the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their pro rata share of the subpart F income (sec. 951). In the case of a corporation that is a CFC for its entire taxable year, and a U.S. shareholder that owns the same proportion of stock in the corporation throughout the corporation's taxable year, the U.S. shareholder's pro rata share of subpart F income is the amount that would have been distributed with respect to the shareholder's stock if on the last day of the corporation's taxable year the CFC had distributed all of its subpart F income pro rata to all of its shareholders.

Under a de minimis rule, none of a CFC's gross income for a taxable year is treated as foreign base company income or subpart F insurance income if the sum of the corporation's gross foreign base company income and gross subpart F insurance income for the year is less than the lesser of 5 percent of its gross income, or $1 million (sec. 954(b)(3)(A)). On the other hand, if more than 70 percent of a CFC's gross income is foreign base company income and/or subpart F insurance income, generally all of its income is treated as foreign base company income or insurance income (whichever is appropriate) (sec. 954(b)(3)(B)).

Income otherwise subject to current taxation as foreign base company income can be excluded from subpart F if the income did not in fact bear a materially lower tax than would be due on the same income earned directly by a U.S. corporation (sec. 954(b)(4)). Under this rule, subpart F income (other than foreign base company oil-related income) does not include items of income received by a CFC if the taxpayer establishes to the satisfaction of the Secretary that the income, measured under U.S. tax rules, was subject to an effective rate of foreign tax equal to at least 90 percent of the maximum U.S. corporate tax rate.

Current inclusion of earnings invested in U.S. property or excess passive assets

In addition to the current inclusion of subpart F income, a 10-percent U.S. shareholder generally is taxable on its pro rata share of the lesser of (1) the foreign corporation's average investment in U.S. property, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis, or (2) the foreign corporation's current or accumulated earnings and profits to the extent that such earnings have not been previously taxed as earnings invested in U.S. property or in excess passive assets; but only to the extent that such lesser amount exceeds the amount of such earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(B), 956, and 959). Similarly, a 10-percent U.S. shareholder generally is taxable on its pro rata share of the lesser of (1) the foreign corporation's average investment in excess passive assets, to the extent that such investment exceeds the foreign corporation's earnings and profits that were previously taxed on that basis, or (2) the foreign

corporation's current or accumulated earnings and profits[2] to the extent that such earnings have not been previously taxed as earnings invested in U.S. property or in excess passive assets; but only to the extent that such lesser amount exceeds the amount of such earnings that have been previously taxed as subpart F income (secs. 951(a)(1)(C), 956A, and 959). The amounts of such investments are measured at the close of each calendar quarter of the taxable year.

Distributions of previously taxed income

Earnings and profits of a CFC that are (or previously have been) included in the incomes of the U.S. shareholders are not taxed again when such earnings are actually distributed to the U.S. shareholders (sec. 959(a)(1)). Similarly, such previously taxed income is not included in the incomes of the U.S. shareholders in the event that such earnings are invested in U.S. property (sec. 959(a)(2)) or in excess passive assets (sec. 959(a)(3)). Previously taxed income actually distributed from a lower-tier CFC to a higher-tier CFC is disregarded in determining the subpart F income of the higher-tier CFC that is included in the income of the U.S. shareholders. In the event that stock in the CFC is transferred subsequent to the income inclusion but prior to the actual distribution of previously taxed income, the transferee shareholder is similarly exempt from tax on the distribution to the extent of the proven identity of shareholder interest.

Distributions by a CFC are allocated first to previously taxed income, then to other earnings and profits (sec. 959(c)). Therefore, a CFC may distribute its previously taxed income to its shareholders, resulting in no additional U.S. income taxation, before it makes any taxable dividend distributions of any current or accumulated non-subpart F earnings and profits. However, distributions for any taxable year are taken into account before income inclusions are determined for that year on account of earnings invested in U.S. property or excess passive assets. Such income inclusions, therefore, generate previously taxed income that can be distributed without further U.S. income taxation beginning in the following taxable year.

Passive foreign investment companies

The 1986 Act established an anti-deferral regime for passive foreign investment companies (PFICs) and established separate rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds," under which electing U.S. shareholders include currently in gross income their respective shares of a PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), under which the U.S. shareholders pay tax on income realized from a PFIC and an interest charge that is attributable to the value of deferral.

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[2] Accumulated earnings and profits are taken into account for this purpose only to the extent that they were accumulated in taxable years beginning after September 30, 1993.

Definition of passive foreign investment company

A PFIC is any foreign corporation if (1) 75 percent or more of its gross income for the taxable year consists of passive income, or (2) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of, passive income (sec. 1296(a)). In the case of a CFC, as well as any other corporation that so elects, the asset test is applied using the adjusted bases of the corporation's assets rather than their fair market value (sec. 1296(a)(2)). Passive income for these purposes generally means income that satisfies the definition of foreign personal holding company income under subpart F (as discussed above); except as provided in regulations, however, passive income does not include certain active-business banking, insurance, or (in the case of the U.S. shareholders of a CFC) securities income, or certain amounts received from a related party (to the extent that the amounts are allocable to income of the related party which is not passive income) (sec. 1296(b)). Passive assets for this purpose are generally those assets that produce or are held for the production of passive income.

Special rules apply for the purpose of measuring the assets of the foreign corporation in the case of certain leased property. The Code treats certain leased property as assets held by the foreign corporation for purposes of the PFIC asset test. This rule applies to tangible personal property with respect to which the foreign corporation is the lessee under a lease with a term of at least 12 months. The measure of leased property for purposes of applying the asset test is the unamortized portion of the present value of the payments under the lease. Property leased by a corporation is not taken into account in testing for PFIC status under the asset test either if the lessor is a related person or if a principal purpose of leasing the property was to avoid the PFIC provisions.

In addition, in measuring the assets of a CFC for purposes of the PFIC asset test, adjusted basis is modified to take into account certain research and experimental expenditures and certain payments for the use of intangible property that is licensed to the CFC. First, the aggregate adjusted basis of the total assets of the CFC is increased by the total amount of research and development expenditures made by the CFC, for qualified research or experimental expenditures (as defined in section 174), taking into account payments and expenditures (including cost-sharing payments) made in the current taxable year and the two most recent preceding taxable years. In addition, the aggregate adjusted basis of the total assets of the CFC is increased by the amount of three times the total payments made during the taxable year to unrelated persons and related U.S. persons for the use of intangible property (as defined in section 936(h)(3)(B)) with respect to which the CFC is a licensee, and which the CFC uses in the active conduct of its trade or business. Payments made to related foreign persons are not taken into account.

In determining whether foreign corporations that own subsidiaries are PFICs, look-through treatment is provided in certain cases (sec. 1296(c)). Under this look-through rule, a foreign corporation that owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation is treated as owning a proportionate part of the other corporation's assets

and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the shareholder's income in applying the income test, and the stock or debt investment is eliminated from the shareholder's assets in applying the asset test.

In addition, interest, dividends, rents, and royalties received from related persons that are not subject to look-through treatment are excepted from treatment as passive income to the extent that, under regulations prescribed by the Secretary, those amounts are allocable to income of the payor that is not passive income (sec. 1296(b)(2)(C)).

In measuring the assets of a foreign corporation, stock of certain U.S. corporations owned by another U.S. corporation which is at least 25-percent owned by the foreign corporation generally is treated as a nonpassive asset (sec. 1297(b)(8)). Under this rule, in determining whether a foreign corporation is a PFIC, stock of a regular domestic C corporation owned by a 25-percent-owned domestic corporation is treated as an asset which does not produce passive income (and is not held for the production of passive income), and income derived from that stock is treated as income which is not passive income.

Special exceptions from PFIC classification apply to start-up companies (sec. 1297(b)(2)) and corporations changing businesses during the taxable year (sec. 1297(b)(3)). In both such cases, a corporation may have a substantially higher proportion of passive assets (and passive income, in some cases) than at other times in its history.

General rule--nonqualified funds

A United States person who is a shareholder in a PFIC that is not a "qualified electing fund" (or has not been a qualified electing fund for all PFIC years in the holding period of the taxpayer) pays U.S. tax and an interest charge based on the value of tax deferral at the time the shareholder disposes of stock in the PFIC or upon receipt of an "excess" distribution (sec. 1291). Under this rule, gain recognized on disposition of stock in a nonqualified fund or income on receipt of an "excess" distribution from a nonqualified fund is treated as ordinary income and is treated as earned pro rata over the shareholder's holding period of his or her investment. The portion treated as earned before the current year during the post-1986 period during which the foreign corporation was a PFIC is taxed at the highest applicable tax rate in effect for each respective year, and is subject to an interest charge. The interest charge is treated as interest for tax purposes. The total of such tax and interest is referred to as the "deferred tax amount." Distributions from nonqualified funds are eligible for direct and deemed-paid foreign tax credits (under secs. 901 and 902) computed under special rules.

An "excess" distribution is any current year distribution in respect of a share of stock that exceeds 125 percent of the average amount of distributions in respect of the share of stock received during the 3 preceding years (or, if shorter, the total number of years of the taxpayer's holding period prior to the current taxable year) (sec. 1291(b)). The determination of an excess distribution excludes from the 3-year average distribution base that part of a prior-year excess

distribution that is considered attributable to deferred earnings (i.e., that part of the excess distribution that was not allocable to pre-1986 or pre-PFIC years or to the current year). Any gain from the sale or disposition of such stock is also treated as an excess distribution. A distribution for this purpose includes any income inclusion on account of earnings of a CFC invested in U.S. property or excess passive assets.

Qualified electing funds

A U.S. person who owns (directly or indirectly under the attribution rules) stock in a PFIC may elect that the PFIC be treated as a "qualified electing fund" with respect to that shareholder (sec. 1295), with the result that the shareholder must include currently in gross income his or her pro rata share of the PFIC's total earnings and profits (sec. 1293). The amount currently included in the income of an electing shareholder is divided between a shareholder's pro rata share of the ordinary income of the PFIC and net capital gain income of the PFIC. This inclusion rule generally requires current payment of tax, absent a separate election to defer such payment. Foreign tax credits are generally allowed against U.S. tax on amounts included in income with respect to a qualified electing fund.

The election for treatment as a qualified electing fund, which is made at the shareholder level, is available only where the PFIC complies with the requirements prescribed in Treasury regulations to determine the income of the PFIC and to ascertain any other information necessary to carry out the purposes of the PFIC provisions. The effect of the election is to treat a PFIC as a qualified electing fund with respect to each electing investor so that, for example, an electing investor will not be subject to the deferred tax and interest charge rules of section 1291 on receipt of a distribution if the election has been in effect for each of the PFIC's taxable years for which the company was a PFIC and which includes any portion of the investor's holding period.

A U.S. shareholder's pro rata share of income generally is determined by aggregating a PFIC's income for the taxable year and attributing that income ratably over every day in the PFIC's year. Electing investors then include in income for the period in which they hold stock in the PFIC their daily ownership interest in the PFIC multiplied by the amount of income attributed to each day.

The distribution of earnings and profits that were previously included in the income of an electing shareholder under these rules is not treated as a dividend to the shareholder, but does reduce the PFIC's earnings and profits (sec. 1293(c)). The basis of an electing shareholder's stock in a PFIC is increased by amounts currently included in income under these rules, and is decreased by any amount that is actually distributed but treated as previously taxed under section 1293(c) (sec. 1293(d)).

U.S. investors in qualified electing funds may generally, subject to the payment of interest, elect to defer payment of U.S. tax on amounts included currently in income but for which no current distribution has been received (sec. 1294). An election to defer tax is treated as an

extension of time to pay tax for which a U.S. shareholder is liable for interest. The disposition of stock in a PFIC generally terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock.

Coordination of rules regarding nonqualified funds and qualified electing funds

Gain recognized on disposition of stock in a PFIC by a U.S. investor and distributions received by the U.S. investor from the PFIC are not taxed under the rules applicable to nonqualified funds (i.e., sec. 1291) if the PFIC is a qualified electing fund for each of the corporation's taxable years which begin after December 31, 1986 and which includes any portion of the investor's holding period (sec. 1291(d)(1)). Therefore, if for any taxable year beginning after December 31, 1986, a foreign corporation is a PFIC but is not a qualified electing fund with respect to the U.S. investor, gains and distributions in any subsequent year will be subject to the rules applicable to nonqualified funds.

Any U.S. person who owns stock (directly or indirectly under the attribution rules) in a PFIC which previously was not a qualified electing fund for a taxable year but which becomes one for the subsequent taxable year may elect to be taxed on the unrealized appreciation inherent in his or her PFIC stock up through the first day of the subsequent taxable year, pay all prior deferred tax and interest, and acquire a new basis and holding period in his or her PFIC investment (sec. 1291(d)(2)). Thereafter, the shareholder is subject to the rules applicable to qualified electing funds.

An alternative election is available to shareholders in a PFIC that is a CFC. Under this alternative, instead of recognizing the entire gain in the value of his or her stock, a U.S. person that holds stock (directly or indirectly under the attribution rules) in a PFIC that is a CFC and that becomes a qualified electing fund can elect to include in gross income as a dividend his or her share of the corporation's earnings and profits accumulated after 1986 and since the corporation was a PFIC. Upon this election, the U.S. person's stock basis is increased by the amount included in income and the shareholder is treated as having a new holding period in his or her stock. Thereafter, the shareholder is subject to the rules applicable to qualified electing funds. The total amount treated as a dividend under the above election is an excess distribution and is to be assigned, for purposes of computing the deferred tax and interest charge, to the shareholder's stock interest on the basis of post-December 31, 1986 ownership.

Overlap between subpart F and the PFIC provisions

A foreign corporation that is a CFC is also a PFIC if it meets the passive income test or the passive asset test described above. In such a case, the 10-percent U.S. shareholders are subject both to the subpart F provisions (which require current inclusion of certain earnings of the corporation) and to the PFIC provisions (which impose an interest charge on amounts distributed from the corporation and gains recognized upon the disposition of the corporation's stock, unless an election is made to include currently all of the corporation's earnings).

If an item of income of a foreign corporation would be includable in the gross income of a U.S. shareholder both under the CFC rules and under the rules relating to the current taxation of income from passive foreign investment companies that are qualified electing funds, that item of income is included only under the CFC rules (sec. 951(f)). Special relief rules apply in the case of a second- (or lower-) tier PFIC that is a qualified electing fund and that is also a CFC.

In the case of a PFIC that is not a qualified electing fund, adjustments to excess distributions are provided for amounts that are taxed currently under the subpart F rules. Thus, excess distributions from a PFIC do not include any amounts that are treated as previously taxed income when distributed by a CFC which is also a PFIC that is not a qualified electing fund.

Description of Proposal

Elimination of overlap between subpart F and the PFIC provisions

In the case of a PFIC that is also a CFC, the proposal would generally treat the corporation as not a PFIC with respect to certain 10-percent shareholders. This rule applies for the portion of the shareholder's holding period with respect to the corporation's stock which is after December 31, 1995 and during which the corporation is a CFC and the shareholder is a United States shareholder within the meaning of section 951(b) (i.e., is subject to subpart F). Accordingly, a shareholder that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally would not also be subject to the PFIC provisions with respect to the same stock. In the case of a PFIC that is also a CFC, the PFIC provisions would continue to apply to those U.S. shareholders that are not subject to subpart F (i.e., shareholders who own less than 10 percent of the corporation's stock by vote).

If a U.S. shareholder of a PFIC that is not a qualified electing fund subsequently becomes subject to subpart F with respect to such corporation, the stock held by such shareholder would continue to be treated as PFIC stock unless the shareholder makes an election to pay tax and an interest charge with respect to the unrealized appreciation in the stock or the accumulated earnings of the corporation. This rule, which applies under current law to PFICs that had been nonqualified funds and that cease to satisfy the tests for PFIC status, would prevent the shareholder from avoiding the interest charge imposed by the PFIC rules with respect to amounts accumulated by the PFIC while the shareholder held stock of the corporation but before the shareholder was subject to subpart F.

If a shareholder ceases to be subject to subpart F with respect to a corporation, for purposes of the PFIC provisions, the shareholder's holding period with respect to such stock would be treated as beginning immediately after such cessation. Accordingly, in applying the rules applicable to PFICs that are not qualified electing funds, the earnings of the corporation would not be attributed to the period during which the shareholder was subject to subpart F and was not subject to the PFIC provisions.

Mark-to-market election

The proposal would allow a shareholder of a PFIC to make a mark-to-market election, provided that the PFIC stock is regularly traded on a national securities exchange or is otherwise treated as marketable under regulations.[3] Under such an election, the shareholder would include in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock over the shareholder's adjusted basis in such stock. The shareholder would be allowed a deduction for the excess, if any, of the adjusted basis of the PFIC stock over its fair market value; however, deductions would be allowable under this rule only to the extent of net mark-to-market gains previously included with respect to such stock.

The shareholder's basis in the PFIC stock would be adjusted to reflect the amounts included or deducted under this election. Amounts included in income (or deducted) pursuant to a mark-to-market election, as well as gain or loss on the actual sale or other disposition of the PFIC stock, would generally be treated as ordinary income (or loss).[4] The source of amounts with respect to a mark-to-market election would be determined in the same manner as if such amounts were gain or loss from the sale of stock in the PFIC.

An election to mark-to-market would apply to the taxable year for which made and all subsequent taxable years, unless the PFIC stock ceases to be marketable or the Secretary of the Treasury consents to the revocation of such election. Under constructive ownership rules, U.S. persons that own PFIC stock through certain foreign entities would be able to make this election with respect to the PFIC. In addition, a CFC that owns stock in a PFIC is treated as a U.S. person that may make the election with respect to such PFIC stock.[5]

In the case of a taxpayer that makes the mark-to-market election with respect to stock in a PFIC that is a nonqualified fund after the beginning of the taxpayer's holding period with respect to such stock, a coordination rule would apply to ensure that the taxpayer does not avoid the interest charge with respect to amounts attributable to periods before such election. A similar rule would apply to regulated investment companies that make the mark-to-market election under this proposal after the beginning of their holding period with respect to PFIC stock (to the extent that the regulated investment company had not previously marked-to-market the stock of the PFIC).

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[3] Except as provided in regulations, PFIC stock held directly or indirectly by a regulated investment company would be treated as marketable stock for purposes of this election.

[4] For purposes of the rules under section 851(b) regarding eligibility as a regulated investment company, income includible pursuant to the election would be treated as a dividend.

[5] Any amount includible (or deductible) in the CFC's gross income pursuant to such election would be treated as foreign personal holding company income (or a deduction allocable to foreign personal holding company income).

A special rule applicable in the case of a PFIC shareholder that becomes a U.S. person would treat the adjusted basis of any PFIC stock held by such person on the first day of the year in which such shareholder becomes a U.S. person as equal to the greater of its fair market value on such date or its adjusted basis on such date. Such rule would apply only for purposes of the mark-to-market election.

The rules of section 1291 (with respect to nonqualified funds) would not apply to a shareholder of a PFIC if a mark-to-market election is in effect for the shareholder's taxable year. Moreover, in applying section 1291 in a case where a mark-to-market election was in effect for any prior taxable year, the shareholder's holding period for the PFIC stock would be treated as beginning immediately after the last taxable year for which such election applied.

Clarifications of definition of passive income

The proposal would clarify the definition of passive income for purposes of the PFIC provisions in two respects. First, the proposal would clarify that the same-country exceptions from the definition of foreign personal holding company income in section 954(c) do not apply in determining passive income for purposes of the PFIC definition Second, the proposal would clarify that foreign trade income of a foreign sales corporation does not constitute passive income for purposes of the PFIC definition.

Effective Date

The proposal would be effective for taxable years of U.S. persons beginning after December 31, 1995, and taxable years of foreign corporations ending with or within such taxable years of U.S. persons.

B. Modifications to Provisions Affecting Controlled Foreign Corporations

Present Law

Treatment of controlled foreign corporation earnings

In general

A U.S. shareholder generally treats dividends from a CFC as ordinary income from foreign sources that carries both direct and indirect foreign tax credits. Under look-through rules, the income and credits are subject to those foreign tax credit separate limitations which are consistent with the character of the income of the foreign corporation.

Several Code provisions result in similar tax treatment of a U.S. shareholder if either it disposes of the CFC stock, or the CFC realizes certain types of income (including income with respect to lower-tier CFCs). First, under section 1248, gain resulting from the disposition by a U.S. person of stock in a foreign corporation that was a CFC with respect to which the U.S. person was a U.S. shareholder in the previous five years is treated as a dividend to the extent of allocable earnings.

Second, a CFC has subpart F income when it realizes gain on a disposition of stock and, ordinarily, when it receives a dividend. Under sections 951 and 960, such subpart F income may result in taxation to the U.S. shareholder similar to that on a dividend from the CFC. In addition to provisions for characterizing income and credits in these situations, the Code also provides certain rules that adjust basis, or otherwise result in modifying the tax consequences of subsequent income, to account for these and other subpart F income inclusions.

Third, when in exchange for property any corporation (including a CFC) acquires stock in another corporation (including a CFC) controlled by the same persons that control the acquiring corporation, earnings of the acquiring corporation (and possibly the acquired corporation) may be treated under section 304 as having been distributed as a dividend to the seller.

For foreign tax credit separate limitation purposes, a CFC is not treated as a noncontrolled section 902 corporation with respect to any distribution out of its earnings and profits for periods during which it was a CFC and except as provided in regulations, the recipient of the distribution was a U.S. shareholder in such corporation.[6] The consequence of not being treated as a

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[6] Under proposed regulations, if a CFC distributes a dividend to an upper-tier CFC or to a United States shareholder that owns directly or indirectly more than 90 percent of the total combined voting power of the CFC at the time of the distribution, and the dividend is attributable to earnings and profits accumulated during a period in which the distributing corporation was a CFC but the 90 percent or more United States shareholder was not a United States shareholder of

noncontrolled section 902 corporation is application of the so-called "look-through" rule. That is, dividends paid by such CFC to its U.S. shareholder are characterized for separate limitation purposes by reference to the character of the underlying earnings of the CFC.

Lower-tier controlled foreign corporations

For purposes of applying the separate foreign tax credit limitations, receipt of a dividend from a lower-tier CFC by an upper-tier CFC may result in a subpart F income inclusion for the U.S. shareholder that is treated as income in the same foreign tax credit limitation category as the income of the lower-tier CFC. The income inclusion of the U.S. shareholder may carry deemed-paid credits for foreign taxes paid by the lower-tier CFC, and the basis of the U.S. shareholder in the stock of the first-tier CFC is increased by the amount of the inclusion. If, on the other hand, the upper-tier CFC sells stock of a lower-tier CFC, then the gain generally is also included in the income of the U.S. shareholder as subpart F income and the U.S. shareholder's basis in the stock of the first-tier CFC is increased to account for the inclusion, but the inclusion is not treated for foreign tax credit limitation purposes by reference to the nature of the income of the lower-tier CFC. Instead it generally is treated as passive income.

If subpart F income of a lower-tier CFC is included in the gross income of a U.S. shareholder, no provision of present law allows adjustment of the basis of the upper-tier CFC's stock in the lower-tier CFC.

Subpart F inclusions in year of disposition

The subpart F income earned by a foreign corporation during its taxable year is taxed to the persons who are U.S. shareholders of the corporation on the last day, in that year, on which the corporation is a CFC. In the case of a U.S. shareholder who acquired stock in a CFC during the year, such inclusions are reduced by all or a portion of the amount of dividends paid in that year by the foreign corporation to any person other than the acquirer with respect to that stock. The reduction is the lesser of the amount of dividends with respect to such stock received by other persons during the year or the amount determined by multiplying the subpart F income for the year by the proportion of the year during which the acquiring shareholder did not own the stock.

Distributions of previously taxed income

If in a year after the year of a subpart F income inclusion, a U.S. shareholder in the CFC receives a distribution from the corporation, the distribution may be deemed to come first out of the corporation's previously taxed income and, therefore, may be excluded from the U.S. shareholder's income. However, a distribution by a foreign corporation to a domestic corporation

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the corporation, the dividend generally would be treated as a dividend from a noncontrolled section 902 corporation. (Prop. Treas. Reg. sec. 1.904-4(g)(3)(ii)).

of earnings and profits previously taxed under subpart F is treated as an actual dividend, solely for purposes of determining the indirect foreign tax credit available to the domestic corporation (sec. 960(a)(3)).

Treatment of U.S. source income earned by a controlled foreign corporation

As a general rule, subpart F income does not include income earned from sources within the United States if the income is effectively connected with the conduct of a U.S. trade or business by the CFC. This general rule does not apply, however, if the income is exempt from, or subject to a reduced rate of, U.S. tax pursuant to a provision of a U.S. treaty.

Indirect foreign tax credits

A U.S. corporation that owns at least 10 percent of the voting stock of a foreign corporation is treated as if it had paid a share of the foreign income taxes paid by the foreign corporation in the year in which the foreign corporation's earnings and profits become subject to U.S. tax as dividend income of the U.S. shareholder (sec. 902(a)). A U.S. corporation may also be deemed to have paid taxes paid by a second- or third-tier foreign corporation. That is, where a first-tier foreign corporation pays a dividend to a 10-percent-or-more U.S. corporate shareholder, then for purposes of deeming the U.S. corporation to have paid foreign tax, the first-tier foreign corporation may be deemed to have paid a share of the foreign taxes paid by a second-tier foreign corporation of which the first-tier foreign corporation owns at least 10 percent of the voting stock, and from which the first-tier foreign corporation received dividends. The same principle applies to dividends from a second-tier or third-tier foreign corporation. No taxes paid by a second- or third-tier foreign corporation are deemed paid by the first- or second-tier foreign corporation, respectively, unless the product of the percentage ownership of voting stock at each level from the U.S. corporation down equals at least 5 percent (sec. 902(b)). Under present law, foreign taxes paid below the third tier of foreign corporations are not eligible for the indirect foreign tax credit.

An indirect foreign tax credit generally is also available to a U.S. corporate shareholder meeting the requisite ownership threshold with respect to inclusions of subpart F income from CFCs (sec. 960(a)).[7] Moreover, an indirect foreign tax credit may also be available to U.S. corporate shareholders with respect to inclusions of income from passive foreign investment companies.

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[7] Unlike the indirect foreign tax credit for actual dividend distributions, the indirect credit for subpart F income inclusions can be available to individual shareholders in certain circumstances if an election is made (sec. 962).

Description of Proposals

Characterization of gain on disposition of stock of lower-tier controlled foreign corporations

The proposal would provide that if a CFC is treated as having gain from the sale or exchange of stock in a foreign corporation, the gain is treated as a dividend to the same extent that it would have been so treated under section 1248 if the CFC were a U.S. person. However, this rule would not affect the determination of whether the second corporation is a CFC.

Gain on disposition of stock in a related corporation created or organized under the laws of, and having substantial part of its assets in a trade or business in, the same foreign country as the gain recipient, even if recharacterized as a dividend under the proposal, would not be excluded from foreign personal holding company income under the same-country exception that applies to actual dividends.

The proposal would repeal the provision added to section 904(d)(2)(E) by the 1988 Act which, except as provided by regulations, requires a recipient of a distribution from a CFC to have been a United States shareholder in that CFC for the period during which the earnings and profits which gave rise to the distribution were generated in order to avoid treating the distribution as one coming from a noncontrolled section 902 corporation.

Effective date.--The proposal would be effective for gains recognized on transactions or distributions occurring after date of enactment.

Subpart F inclusions in year of disposition

Where a U.S. shareholder acquires the stock of a CFC from another U.S. shareholder during the middle of a year in which the CFC earns subpart F income, the proposal would reduce the acquirer's subpart F inclusion for that year by a portion of the amount of the dividend deemed (under sec. 1248) to be received by the transferor. The portion by which the inclusion is reduced would not exceed the subpart F inclusion for that year times the proportion of the year for which the acquirer did not own the stock.

Effective date.--The proposal would be effective for dispositions occurring after date of enactment.

Adjustments to basis of stock held by foreign corporations

The proposal would provide that when a lower-tier CFC earns subpart F income, and stock in that corporation is later sold by an upper-tier CFC, the resulting income inclusion of the U.S. shareholders are, under regulations, adjusted to account for previous inclusions, in a manner similar to the adjustments now provided to the basis of stock in a first-tier CFC.

Effective date.--The proposal would be effective for adjustments attributable to inclusions for taxable years of U.S. shareholders beginning after December 31, 1995.

Avoiding double inclusions in other cases

The proposal would contemplate that in the case of a cross-chain section 304 dividend out of the earnings of CFCs that were previously included in the income of a U.S. shareholder under subpart F, the Treasury Secretary in his discretion may by regulation treat such dividends as distributions of previously taxed income, with appropriate basis adjustments. In addition to cases involving section 304, the proposal would provide that the Secretary may by regulation modify the application of subpart F in any other case where there would otherwise be a multiple inclusion of any item of income (or an inclusion or exclusion without an appropriate basis adjustment) by reason of the structure of a U.S. shareholder's holdings in CFCs or by reason of other circumstances.

Effective date.--The proposal would be effective on the date of enactment.

Treatment of United States income earned by a controlled foreign corporation

The proposal would provide that an exemption or reduction by treaty of the branch profits tax that would be imposed under section 884 on a CFC does not affect the general statutory exemption from subpart F income that is granted for U.S. source effectively connected income.

Effective date.--The proposal would be effective for taxable years beginning after 1986.

Indirect foreign tax credit allowed for certain lower-tier companies

The proposal would extend the application of the indirect foreign tax credit (secs. 902 and 960) to certain taxes paid or accrued by certain fourth-, fifth-, and sixth-tier foreign corporations. In general, three requirements must be satisfied by a foreign company at any of these tiers to qualify for the credit. First, the company must be a CFC. Second, the domestic corporation referred to in section 902(a) must be a U.S. shareholder (as defined in section 951(b)) with respect to the foreign company. Third, the product of the percentage ownership of voting stock at each level from the U.S. corporation down must equal at least 5 percent. The proposal would limit the application of the indirect foreign tax credit below the third tier to taxes paid or incurred in taxable years during which the payor is a CFC. No inference is intended as to the availability of indirect foreign tax credits, under present law, for taxes paid by foreign corporations in the first three tiers, for periods prior to the time when the present-law ownership requirements were met as to those corporations. All foreign taxes paid below the sixth tier of foreign corporations remain ineligible for the indirect foreign tax credit.

Effective date.--The proposal would be effective for foreign taxes paid or incurred by CFCs for taxable years of such corporations beginning after the date of enactment. In the case of any chain of foreign corporations the taxes of which would be eligible for the indirect foreign tax credit, under present law or under the proposal, but for the denial of indirect credits below the third or sixth tier, as the case may be, no liquidation, reorganization, or similar transaction in a taxable year beginning after the date of enactment shall have the effect of permitting taxes to be taken into account under the indirect foreign tax credit provisions of the Code which could not have been taken into account under those provisions but for such transaction.

Legislative Background

The proposals were included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposals also were included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

C. Other Foreign Provisions

1. Exchange rate used in translating foreign taxes into U.S. dollar amounts

Present Law

Foreign income taxes paid in foreign currencies are required to be translated into U.S. dollar amounts using the exchange rate as of the time such taxes are paid to the foreign country or U.S. possession (sec. 986(a)(1)). This rule applies equally to foreign taxes paid directly by U.S. taxpayers, which taxes are creditable only in the year paid or accrued (or during a carryover period), and to foreign taxes paid by foreign corporations that are deemed paid by a U.S. corporation, and hence creditable, in the year that the U.S. corporation receives a dividend or income inclusion.

For taxpayers who utilize the accrual basis of accounting for determining creditable foreign taxes, accrued and unpaid foreign tax liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the exchange rate as of the last day of the taxable year of accrual.[8] In certain cases where a difference exists between the dollar value of accrued foreign taxes and the dollar value of those taxes when paid, a redetermination (or adjustment) of foreign taxes is required.[9] Generally, such an adjustment may be attributable to one of three causes. One cause would be a refund of foreign taxes. Second, a foreign tax redetermination may be required because the amount of foreign currency units actually paid differs from the amount of foreign currency units accrued. These first two cases generally give rise to a so-called "section 905(c) regular adjustment." Third, a redetermination may arise due to fluctuations in the value of the foreign currency relative to the dollar between the date of accrual and the date of payment. This third case gives rise to a so-called "section 905(c) translation adjustment."

As a general matter, a redetermination of foreign tax paid or accrued directly by a U.S. person requires notification of the Internal Revenue Service and a redetermination of U.S. tax liability for the taxable year for which the foreign tax was claimed as a credit. Exceptions to this rule apply for de minimis amounts of foreign tax redetermination.[10] In the case of redetermination of foreign taxes that qualify for the indirect (or "deemed-paid") foreign tax credit under sections 902 and 960, taxpayers generally are required to make appropriate adjustments to the relevant pools of earnings and profits and foreign taxes.[11]

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[8] Temp. Treas. Reg. sec. 1.905-3T(b)(1).

[9] Temp. Treas. Reg. sec. 1.905-3T(c).

[10] Temp. Treas. Reg. sec. 1.905-3T(d)(1).

[11] Temp. Treas. Reg. sec. 1.905-3T(d)(2); Notice 90-26, 1990-1 C.B. 336.

Description of Proposal

The proposal would set forth two sets of operating rules for the translation of foreign taxes. The first set would establish new rules for the translation of certain accrued foreign taxes. The other set would modify the rules of present law for translating all other foreign taxes. The proposal would also modify the provisions relating to redetermination of foreign taxes.

Translation of foreign taxes

The proposal generally would permit accrual-basis taxpayers to accrue foreign taxes at the average exchange rate for the taxable year to which such taxes relate. If tax in excess of the accrued amount is actually paid, such excess amount would be translated using the exchange rate in effect as of the time of payment. This set of rules would not apply (1) to any foreign income tax paid after the date two years after the close of the taxable year to which such taxes relate, (2) with respect to taxes of an accrual-basis taxpayer that are actually paid in a taxable year prior to the year to which they relate, or (3) to the extent provided in regulations, to tax payments that are denominated in a currency determined to be an inflationary currency in accordance with such regulations.

Foreign taxes not eligible for application of the preceding rules generally would be translated into U.S. dollars using the exchange rates as of the time such taxes are paid. The Secretary of the Treasury would be granted authority to issue regulations that would allow foreign tax payments made by a foreign corporation or by a foreign branch of a U.S. person to be translated into U.S. dollar amounts using an average U.S. dollar exchange rate for a specified period.

Effective date.--This part of the proposal would be effective for foreign taxes which relate to taxable years beginning after December 31, 1995.

Redetermination of foreign taxes

The proposal would amend section 905(c) to require foreign tax redetermination to occur in three cases: (1) if accrued taxes when paid (in foreign currency) differ from the amounts claimed (in foreign currency) as credits by the taxpayer, (2) if accrued taxes are not paid before the date two years after the close of the taxable year to which such taxes relate, and (3) if any tax paid is refunded in whole or in part. Thus, for example, if at the close of the second taxable year after the close of the taxable year to which an accrued tax relates, any portion of the tax so accrued has not yet been paid, a foreign tax redetermination under section 905(c) would be required for the amount representing the unpaid portion of that accrued tax. That is, the accrual of any tax that is unpaid as of that date would be retroactively denied and any such taxes if subsequently paid are taken into account for the taxable year in which paid.

Effective date.--This part of the proposal would be apply to foreign taxes paid or accrued

after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

2. Election to use simplified foreign tax credit limitation under the alternative minimum tax

Present Law

Computing foreign tax credit limitations requires the allocation and apportionment of deductions between items of foreign source income and items of U.S. source income. Foreign tax credit limitations must be computed both for regular tax purposes and for purposes of the alternative minimum tax (AMT). Consequently, after allocating and apportioning deductions for regular tax foreign tax credit limitation purposes, additional allocations and apportionments generally must be performed in order to compute the AMT foreign tax credit limitation.

Description of Proposal

The proposal would permit taxpayers to elect to use as their AMT foreign tax credit limitation fraction the ratio of foreign source regular taxable income to entire alternative minimum taxable income, rather than the ratio of foreign source alternative minimum taxable income to entire alternative minimum taxable income. Foreign source regular taxable income would be permitted to be used, however, only to the extent it does not exceed entire alternative minimum taxable income. In the event that foreign source regular taxable income does exceed entire alternative minimum taxable income, and the taxpayer has income in more than one foreign tax credit limitation category, it is intended that the foreign source taxable income in each such category generally would be reduced by a pro rata portion of that excess.

The proposed election would be available only in the first taxable year beginning after December 31, 1995, for which the taxpayer claims an AMT foreign tax credit. It is intended that a taxpayer would be treated, for this purpose, as claiming an AMT foreign tax credit for any taxable year for which the taxpayer chooses to have the benefits of the foreign tax credit, and in which the taxpayer is subject to the alternative minimum tax or would be subject to the alternative minimum tax but for the availability of the AMT foreign tax credit. The election would apply to all subsequent taxable years, and would be permitted to be revoked only with the consent of the Secretary of the Treasury.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

3. Treatment of inbound and outbound transfers

Present Law

Outbound transfers

Corporate nonrecognition provisions

Certain types of exchanges relating to the organization, reorganization, and liquidation of a corporation can be made without recognition of gain to the corporation involved or to its shareholders. In 1932, Congress enacted an exception to the nonrecognition rules, which became section 367 of the 1954 Code, for the case where such an exchange involves a foreign corporation. The legislative history indicates that the exception was enacted in order to prevent tax avoidance that might have otherwise occurred upon the transfer of appreciated property outside U.S. tax jurisdiction.[12] Under that provision, in determining the extent to which gain (but not loss) was recognized in these exchanges, a foreign corporation was not considered a corporation unless it was established to the satisfaction of the IRS that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

The Code now provides that if a U.S. person transfers property to a foreign corporation in connection with certain corporate organizations, reorganizations, or liquidations, the foreign corporation will not, for purposes of determining the extent to which gain is recognized on such transfer, be considered to be a corporation (sec. 367(a)(1)). Various exceptions to the operation of this rule are provided, including a broad grant of authority to provide exceptions by regulation. The statutory language has changed substantially since 1932, but it has retained in large part its primary operational mechanism--that of treating a foreign corporation as not a corporation. Because corporate status is essential to qualify for the tax-free organization, reorganization, and liquidation provisions, failure to satisfy the requirements of section 367 could result in the recognition of gain to the participant corporations and shareholders.

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[12] H.R. Rep. No. 708, 72d Cong., 1st Sess. 20 (1932).

Excise tax on transfers to a foreign entity

At the same time that Congress enacted the original predecessor of current section 367, Congress also enacted an excise tax on outbound transfers that might not constitute income tax recognition events even after imposition of the anti-avoidance income tax rule adopted for corporate transactions. As in the case of the corporate nonrecognition override provision, the purpose of the excise tax was to check transfers of appreciated property to foreign entities for the purpose of avoidance of taxes on capital gains.[13] Therefore, as in the case of the corporate provision, the excise tax generally has been imposed only in certain cases where it has been believed necessary or appropriate to preserve U.S. tax on appreciated assets.

Under present law, the excise tax generally applies on transfers of property by a U.S. person to a foreign corporation--as paid-in surplus or as a contribution to capital--or to a foreign estate, trust, or partnership.[14] The tax is 35 percent of the amount of gain inherent in the property transferred, but not recognized for income tax purposes at the time of the transfer (sec. 1491). For income tax purposes, the basis of the appreciated property whose transfer triggers the tax is not increased to account for imposition of the tax.

The excise tax does not apply in certain cases where the transferee is exempt from U.S. tax under Code sections 501-505 (sec. 1492(1)). In addition, the excise tax does not apply in some cases where income tax rules governing outbound transfers apply, either by their terms or by the election of the taxpayer. Thus, the excise tax does not apply to a transfer described in section 367, or to a transfer not described in section 367 but with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of section 367 (sec. 1492(2)).

In addition, a taxpayer may elect (under regulations prescribed by the Secretary) to treat a transfer described in section 1491 as a sale or exchange of the property transferred and to recognize as gain (but not loss) in the year of the transfer the excess of the fair market value of the property transferred over the adjusted basis (for determining gain) of the property in the hands of the transferor (sec. 1057). To the extent that gain is recognized pursuant to the election in the year of the transfer, the transfer is not subject to the excise tax, and the basis of the property in the hands of the transferee will be increased by the amount of gain recognized (sec. 1492(3)).

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[13] Id. at 52.

[14] The Internal Revenue Service has in the past wavered on the question whether this tax applies to a transfer to a foreign trust with respect to which the transferor is treated as the owner under the grantor trust rules. Compare Rev. Rul. 69-450, 1969-2 C.B. 168 (holding that such a transfer is subject to tax under section 1491); with Rev. Rul. 87-61, 1987-2 C.B. 219 (revoking Rev. Rul. 69-450, and holding that such a transfer is not subject to tax under section 1491).

The legislative history of the elective income recognition provision indicates that the making of an election which has as one of its principle purposes the avoidance of Federal income taxes is not permitted.[15]

The excise tax is due at the time of the transfer (sec. 1494(a)). Under regulations, the excise tax may be abated, remitted, or refunded if the taxpayer, after the transfer, elects the application of principles similar to the principles of section 367 (sec. 1494(b)).

Inbound corporate transfers

Although the legislative history of the 1932 Act indicated a concern with outbound transfers, the statutory standard for determining that a transaction did not have as one of its principal purposes tax avoidance evolved through administrative interpretation into a requirement that, in the case of transfers into the United States by a foreign corporation, tax-free treatment generally would be permitted only if the U.S. tax on accumulated earnings and profits was paid. For example, in 1968, the IRS issued guidelines (Rev. Proc. 68-23, 1968-1 C.B. 821) as to when favorable rulings "ordinarily" would be issued. As a condition of obtaining a favorable ruling with respect to certain transactions, the section 367 guidelines required the taxpayer to agree to include certain items in income (the amount to be included was called the section 367 toll charge). For example, if the transaction involved the liquidation of a foreign corporation into a domestic parent corporation, a favorable ruling was issued if the domestic parent agreed to include in its income as a dividend for the taxable year in the which the liquidation occurred the portion of the accumulated earnings and profits of the foreign corporation which was properly attributable to the domestic corporation's stock interest in the foreign corporation (Rev. Proc. 68-23, sec. 3.01(1); see also sec. 3.03(1)(b)).

Absence of a toll charge on accumulated earnings of a foreign corporation upon liquidation or asset reorganization into a U.S. corporation clearly would permit avoidance of tax. For example, if a U.S. corporation owns 100 percent of the stock of a U.S. subsidiary, no tax is imposed either on a dividend from the subsidiary to the parent (sec. 243) or the liquidation of the subsidiary into the parent (secs. 332 and 337). In each case, the earnings of the subsidiary already have been subject to U.S. tax jurisdiction, and the liquidation provisions allow nonrecognition of gain inherent in appreciated property of the subsidiary. On the other hand, if a U.S. corporation owns 100 percent of the stock of a foreign subsidiary, earnings of the subsidiary generally are not subject to current U.S. tax. Instead, tax generally is imposed on a dividend from the subsidiary to the parent, net of creditable foreign taxes. If a liquidation of the subsidiary could be accomplished tax-free under the Code, U.S. tax on its earnings would be avoided; more generally, the parent would be able to succeed to the basis and other tax attributes of the foreign corporation without having subjected to U.S. tax jurisdiction the earnings that gave rise to those tax attributes.

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[15]Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 226 (1976).

For purposes of the transactions described above, section 367 (and its predecessors) remained largely unchanged between 1932 and 1976. In 1976, however, a number of problems caused Congress to revise section 367. One result of the 1976 revision was to separate the provision into two sets of rules: one set dealing with outbound transfers, where the statutory aim is to prevent the removal of appreciated assets or inventory from U.S. tax jurisdiction prior to their sale (sec. 367(a)), and the other set dealing with both transfers into the United States and those which are exclusively foreign (sec. 367(b)).

Section 367(b) now provides, in part, that in the case of certain exchanges in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation will be considered to be a corporation except to the extent provided in regulations which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Although it is clear that absence of a toll charge on accumulated earnings of a foreign corporation upon liquidation or reorganization into a U.S. corporation leads to avoidance of tax, and Congress in 1976 noted without disapproval the adoption of IRS positions that would prevent the avoidance of tax in these cases,[16] neither section 367(b) as revised in 1976, nor its predecessors, were drafted in such a way that directly causes tax to be imposed on foreign earnings.

For example, assume that a U.S. corporation owns 100 percent of the stock of a liquidating foreign corporation, and, pursuant to regulations under section 367(b), the foreign corporation is not treated as a corporation for purposes of section 332. In that case, the U.S. corporation would be required under the Code to recognize the difference between the basis and the value of its stock in the foreign corporation. That gain, however, may be more or less than the accumulated earnings of the foreign corporation attributable to the period when the U.S. corporation owned the stock of the foreign corporation.

Perhaps as a result, neither the present temporary regulations nor the proposed regulations under section 367(b) mandate a tax based on the accumulated earnings of a foreign corporation that liquidates or reorganizes into a U.S. corporation. The temporary regulations allow the taxpayer to elect treatment of the foreign corporation as a corporation if the tax on earnings is paid. If the taxpayer chooses not to make the election, the foreign corporation is not treated as a corporation under the relevant nonrecognition provision (e.g., sec. 332, 354), but is treated as a corporation for other purposes, such as for purposes of the basis rules (secs. 334, 358, 362), and carryover provisions (sec. 381) (Temp. Treas. Reg. secs. 7.367(b)-5(b) and 7.367(b)-7(c)(2)). The proposed regulations generally require that the foreign corporation be treated as a corporation, and permit the taxpayer to elect either to pay the tax on earnings, or to pay tax on the gain; but if the latter option is chosen, adjustments must be made to either net operating loss

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[16] E.g., Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 264 (1976).

carryovers, capital loss carryovers, or asset bases (Proposed Treas. Reg. sec. 1.367(b)-3(b)(2)).

Description of Proposal

Outbound transfers

The proposal would repeal the excise tax on outbound transfers. In its place, the proposal would require the full recognition of gain on a transfer of property by a U.S. person to a foreign corporation as either paid-in surplus or a contribution to capital, or to a foreign estate, trust, or partnership. Under the proposal, the Secretary of the Treasury would be permitted, however, in lieu of applying this full recognition rule, to provide regulations under which principles similar to the principles of section 367 would apply to any such transfer. Moreover, the Secretary would be permitted to provide rules under which recognition of gain would not be triggered by section 1491 in cases where the Secretary is satisfied that application of other Code rules (such as those relating to partnerships or trusts) would prevent the avoidance of tax consistent with the purposes of the proposal. Full recognition of gain could also be avoided in the case of a transfer described in section 367. It is anticipated that, prior to the promulgation of regulations, the Secretary generally would continue to permit taxpayers to elect the application of principles similar to the principles of section 367, provided the election is made by the time for filing the income tax return for the taxable year of the transfer.

Inbound transfers

The proposal would provide that in the case of certain corporate organizations, reorganizations, and liquidations described in section 332, 351, 354, 355, 356, or 361 in which the status of a foreign corporation as a corporation is a condition for nonrecognition by a party to the transaction, income would be recognized to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes. This provision would be limited in its application, under the proposal, so as not to apply to a transaction in which the foreign corporation is not treated as a corporation under section 367(a)(1). Thus, the proposal would permit the Secretary to provide by regulations for recognition of income, without regard to the amount of gain that would be recognized in the absence of the relevant nonrecognition provision listed above. As under current law, such regulations would be subject to normal court review as to whether they are necessary or appropriate for the prevention of avoidance of Federal income taxes.

In addition, the proposal clarifies that rules for income recognition under section 367(b) could also be applied in a case involving a transfer literally described in section 367(a)(1), where necessary or appropriate to prevent the avoidance of Federal income taxes.

Effective Date

The proposal would apply to transfers after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

4. Application of uniform capitalization rules to foreign corporations

Present Law

In general

For purposes of computing a taxpayer's taxable income and earnings and profits, certain costs reduce net income as they are incurred (e.g., ordinary and necessary business expenses); other costs reduce net income only to the extent that the income-producing assets with which those costs are associated generate income. Pursuant to the Code, Treasury Regulations prescribe a set of rules for this purpose (the "uniform capitalization rules") which require certain costs--including both direct and indirect costs allocable to property--to be capitalized or included in inventories. The uniform capitalization rules generally apply to property produced by a taxpayer or acquired by a taxpayer for resale.

In the case of interest expense, the uniform capitalization rules apply only to interest that is paid or incurred during the property's production period[17] and that is allocable to property produced by the taxpayer or acquired for resale which (1) is either real property or property with a class life of at least 20 years, (2) has an estimated production period exceeding 2 years, or (3) has an estimated production period exceeding 1 year and a cost exceeding $1,000,000 (sec. 263A(f)).

Application to foreign persons

The uniform capitalization rules apply to foreign persons, whether or not engaged in business in the United States. In the case of a foreign corporation carrying on a U.S. trade or business, for example, the uniform capitalization rules apply for purposes of computing the corporation's U.S. effectively connected taxable income, as well as computing its effectively connected earnings and profits for purposes of the branch profits tax.

When a foreign corporation is not engaged in business in the United States, its taxable income and earnings and profits may nonetheless be relevant under the Code. For example, the pro-rata share of the subpart F income of a CFC is currently includible on the return of a U.S.

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[17] The production period with respect to a property is the period beginning on the date on which production of the property begins and ending on the date on which the property is ready to be placed in service or to be held for sale.

shareholder of the CFC. And whether or not a foreign corporation is U.S.-controlled, its accumulated earnings and profits must be computed in order to determine the indirect foreign tax credit carried by distributions from the foreign corporation to any domestic corporation that owns at least 10 percent of its voting stock.

The Code provides that the earnings and profits or deficit in earnings and profits of any foreign corporation, for any taxable year, shall be determined according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary of Treasury (sec. 964(a)). Thus, foreign persons generally are required to capitalize costs in accordance with the uniform capitalization rules.

Under Notice 88-104[18] foreign persons may elect a simplified "U.S. ratio" method of accounting for costs other than interest that are required to be capitalized. To apply the U.S. ratio method, there must be a U.S. trade or business carried on by the person carrying on the foreign business, or by a related party. The U.S. business so carried on that is the same or most similar to the foreign business must distinguish between costs capitalized in the basis of its relevant property before application of the uniform capitalization rules, and costs capitalized only as a result of those rules, and compute the ratio of the latter to the former ("the U.S. ratio"). The foreign business multiplies this U.S. ratio by the amount of its costs capitalized (without regard to the uniform capitalization rules) in the basis of its relevant property. The product of this multiplication yields the amount of additional costs (other than interest) required to be capitalized by a foreign person under the uniform capitalization rules.[19]

All expenses that the foreign person otherwise treats as deductible are decreased ratably, to equal the amount of the increase in costs capitalized under the U.S. ratio method for the taxable year. The appropriate ratio is applied to the costs of property produced or property acquired for resale incurred by the foreign person for each taxable year. A separate ratio is required to be computed for each taxable year for properties related to each separate trade or business.

Capitalization of interest expense

The IRS has also provided advance guidance on the application of the interest capitalization rules of section 263A(f).[20] Under the interest capitalization rules, taxpayers must first capitalize debt which is directly attributable to the production expenditures of a property specified in section 263A(f)(1)(B) (i.e., "traced debt"). Debt generally is allocated to a particular expenditure by tracing disbursements of the debt proceeds to that expenditure. Traced debt

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[18] 1988-2 C.B. 443.

[19] "Additional section 263A costs" as defined in Temp. Treas. Reg. sec. 1.263A-1T(b)(5)(iii).

[20] Notice 88-99, 1988-2 C.B. 422.

includes only amounts of the taxpayer's eligible debt that do not exceed the property's accumulated production expenditures.

After determining the amount of traced debt directly attributable to the property's production expenditures, taxpayers then must assign any other eligible debt to any remaining production expenditures and interest on such debt must be capitalized, to the extent that the taxpayer's interest costs could have been reduced if such production expenditures had not been incurred (i.e., "avoided cost debt").[21] The determination of whether the taxpayer's interest costs could have been reduced if such production expenditures had not been incurred is made by assuming that the amounts expended for production had instead been used to repay the taxpayer's debt, thus reducing the principal balance of such debt and the interest costs thereon. The operation of the avoided cost concept does not depend on whether, in fact, the taxpayer actually would have used the amounts otherwise expended for production to repay debt.

Capitalization of the interest of parties related to producers of property

The interest costs of parties (including foreign corporations) related to the taxpayer producing qualified property can also be subjected to capitalization requirements (and avoided cost rules).[22] In the case of related parties to which the avoided cost rules apply, a deferred asset method generally is used to comply with the interest capitalization requirements. Under this method, the related party is required to capitalize interest equal to an amount that the producing taxpayer would have capitalized, using the avoided cost principles, had the producing taxpayer itself incurred the interest on the eligible debt of the related party.[23]

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[21] Notice 88-99 allows taxpayers to elect to forego the debt tracing step by treating all of its debt that would be traced debt as avoided cost debt.

[22] For taxable years of the producing taxpayer beginning on or after January 1, 1988, a person is considered related to the producing taxpayer if such person and the taxpayer are members of the same parent-subsidiary controlled group of corporations as defined in section 1563(a)(1) regardless of whether such persons would be treated as component members of such group under section 1563(b). For this purpose, the constructive ownership rules of section 1563(e) apply. See Notice 88-99. Thus, a foreign corporation may be treated as a member of a controlled group, even though it is not a member of the consolidated group, and thus may be subject to the interest capitalization and avoided cost rules.

[23] The interest incurred by related parties is subject to these rules only if the producing taxpayer's accumulated production expenditures exceed the total amount of its traced and avoided cost debt, and only if interest on the eligible debt of related parties has not already been allocated by the related party with respect to its own production expenditures of qualified property for the taxable year.

Under the deferred asset method, the related party accounts for capitalized interest as an asset in the same manner (and at the same time) as the producing taxpayer would have accounted for such interest had the interest been capitalized into the basis of the qualified property on the taxpayer's books and records. The interest capitalized by the related party is then recovered at the same time and in the same manner as it would have been recovered had it been capitalized into the basis of the property produced by the taxpayer.[24]

A producing taxpayer may elect to use a substitute cost method instead of subjecting the related party to the deferred asset method. Under the substitute cost method, the producing taxpayer capitalizes, during each year of the production period, certain "substitute" costs in lieu of the taxpayer's related parties being required to capitalize interest on their related party avoided cost debt.

For taxable years of producing taxpayers beginning on or after January 1, 1988, if interest incurred by related parties becomes subject to the interest capitalization rules, the following ordering rules apply in determining which related party's interest is first capitalized, and in determining the production expenditures of which producing taxpayer are first subject to the deferred asset method: (1) with respect to producing taxpayers organized outside of the United States, interest incurred by every related party organized outside the United States must be capitalized before the interest of any other related party is capitalized; (2) with respect to producing taxpayers organized within the United States, interest incurred by every related party organized within the United States must be capitalized before the interest of any other related party is capitalized.

Description of Proposal

The proposal would provide an election for a foreign corporation not to apply the uniform capitalization rules with respect to its activities in a taxable year during which (1) such corporation is not engaging in a U.S. trade or business and (2) its activities do not give rise to income inclusion by its U.S. shareholders under the subpart F provisions of the Code. Exemption from uniform capitalization rules under the proposal would constitute a change in accounting method of the foreign corporation adopted with the consent of the Secretary of Treasury. No section 481(a) adjustment would be required in connection with such change; instead, the cut-off method would apply. Under the cut-off method, the value of the beginning inventory of an affected taxpayer would include amounts properly capitalized in a previous year under the uniform capitalization rules and the taxpayer would not apply the uniform capitalization rules with respect to inventory acquired or produced during the year for which the election is in effect.

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[24] In the event that the related party leaves the controlled group, the producing taxpayer increases its basis in the qualified property by the amount remaining in the deferred asset account of the related party that corresponds to the particular qualified property. The former related party is not permitted to continue to amortize, deduct, or take into account the capitalized interest.

Effective Date

The proposal would apply to taxable years of the foreign corporation beginning after December 31, 1995.

5. Modification of reporting threshold for stock ownership of a foreign corporation

Present Law

U.S. persons who own or acquire 5 percent or more of the value of the stock of a foreign corporation, others who become U.S. persons while owning that percentage of the stock of a foreign corporation, and U.S. citizens and residents who are officers or directors of foreign corporations with such U.S. ownership are required to file information returns concerning the corporation and its shareholders (sec. 6046; see schedule O (form 5471)). Regulations excuse any shareholder from furnishing required information if it is furnished by another person having an equal or greater stock interest in the corporation (Treas. Reg. sec. 1.6046-1(e)(5)).

Description of Proposal

The proposal would increase the 5-percent reporting threshold under section 6046 for stock ownership of a foreign corporation to 10 percent.

Effective Date

The proposal would be effective for reportable events that occur after December 31, 1995.

6. Prizes and awards received by a nonresident alien relating to amateur sports competitions held in the United States

Present Law

There are no specific statutory or regulatory provisions with respect to the source of income from prizes and awards received by a nonresident alien athlete who competes in the United States in a sports contest. The IRS has taken the position that prizes and awards associated with such competitions are treated as services income derived from U.S. sources, regardless of whether the athlete is a professional or an amateur and regardless of the size of the award. U.S. source services income earned by a nonresident alien is generally subject to U.S. income tax at graduated rates.

Description of Proposal

The proposal would treat prizes and awards received by a nonresident alien from participating in an amateur sports competition held within the United States as foreign source

income if the recipient does not perform any services for the payor. Thus, the value of the prize or award would be exempt from U.S. income tax. For this purpose, amateur sports competition means any competition in which the only prizes awarded by the sponsors are of nominal value.

Effective Date

The proposal would be effective for prizes and awards received on or after the enactment date.

7. Conform estate and income tax treatments of certain short-term OID obligations held by a non-resident alien

Present Law

The United States imposes estate tax on assets of noncitizen nondomiciliaries that were situated in the United States at the time of the individual's death. Debt obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia are considered property located within the United States if held by a nonresident not a citizen of the United States (sec. 2014(c)).

Special rules apply to treat certain bank deposits and debt instruments the income from which qualifies for the bank deposit interest exemption and the portfolio interest exemption as property from without the United States despite the fact that such items are obligations of a U.S. person, the United States, a political subdivision of a State, or the District of Columbia (sec. 2105(b)). Income from such items is exempt from U.S. income tax in the hands of the nonresident recipient (secs. 871(h) and 871(i)(2)(A)). The effect of the special rules is to exclude these items from the U.S. gross estate of a nonresident not a citizen of the United States. However, no equivalent exemption is available for obligations that generate short-term OID income despite the fact that such income also is exempt from U.S. income tax in the hands of the nonresident recipient (sec. 871(g)(1)(B)(i)).

Description of Proposal

The proposal would treat any debt obligation the income from which would be eligible for the exemption for short-term OID under section 871(g)(1)(B)(i) if such income were received by the decedent on the date of his death as property located outside of the United States in determining the U.S. estate tax liability of a nonresident not a U.S. citizen.

Effective Date

The proposal would be effective for estates of decedents dying after the date of enactment.

8. Repeal of excess passive assets provision (sec. 956A)

Present Law

The United States taxes U.S. citizens and resident individuals and U.S. corporations (collectively, U.S. persons) on their worldwide income, subject to the allowance of a credit for foreign income taxes paid with respect to foreign source income. In contrast, the United States taxes nonresident aliens and foreign corporations only on income that is effectively connected with a U.S. business and on certain passive income (e.g., dividends and interest) from U.S. sources.

Absent an applicable anti-deferral rule, a U.S. person that conducts foreign operations through a foreign corporation would not be subject to U.S. tax on the income from such operations until the income is repatriated to the United States through a dividend distribution from the foreign corporation, subject to a foreign tax credit. However, the U.S. tax law contains anti-deferral regimes that apply in certain cases to require current U.S. taxation of income earned through foreign corporations.

Under the rules of subpart F (secs. 951-964), the United States shareholders (as defined in sec. 951(b)) of a CFC are required to include in income currently for U.S. tax purposes certain earnings of the CFC, whether or not such earnings are actually distributed currently to the shareholders.[25] The United States shareholders of a CFC are subject to current U.S. tax on their shares of certain income earned by the CFC (referred to as "subpart F income"). Subpart F income generally represents passive income and other income that is considered relatively moveable from one taxing jurisdiction to another.[26] The United States shareholders of the CFC are also subject to current U.S. tax on their shares of the CFC's earnings to the extent such earnings are invested by the CFC in certain U.S. property (e.g., a loan to the CFC's U.S. parent or an investment in U.S. real estate).

In addition to these current inclusions rules, the Omnibus Budget Reconciliation Act of 1993 enacted section 956A, which applies another current inclusion rule to United States shareholders of a CFC. Under section 956A, the United States shareholders of a CFC are

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[25] For purposes of the subpart F rules, a United States shareholder is a U.S. person that owns 10 percent or more of the CFC's stock (measured by vote only). A CFC is a foreign corporation in which such United States shareholders own more than 50 percent of the stock (measured by vote or by value).

[26] Subpart F income generally includes insurance income; investment-type income such as dividends, interest, rents, royalties, and gains on the sale of investment property (referred to as foreign personal holding company income); income from certain related-party sales; income from certain services for a related party; foreign shipping income; and certain foreign oil-related income.

required to include in income currently their shares of the CFC's earnings to the extent invested in excess passive assets. A CFC has excess passive assets for a taxable year if the average of the amounts of its passive assets exceeds 25 percent of the average of the amounts of its total assets; this calculation requires a quarterly determination of the CFC's passive assets and total assets. Special rules apply in defining passive assets, in measuring the CFC's assets, and in aggregating related CFCs for purposes of making the excess passive assets determination. Section 956A applies to earnings of a CFC accumulated in taxable years beginning after September 30, 1993.

Description of Proposal

The proposal would repeal section 956A.

Effective Date

The proposal would be effective for taxable years of United States shareholders beginning after September 30, 1995, and taxable years of foreign corporations ending with or within such taxable years of United States shareholders.

V. OTHER INCOME TAX SIMPLIFICATION PROVISIONS

A. Provisions Relating to Subchapter S Corporations

1. Increase number of eligible shareholders

Present Law

The taxable income or loss of an S corporation is taken into account by the corporation's shareholders, rather than by the entity, whether or not such income is distributed. A small business corporation may elect to be treated as an S corporation. A "small business corporation" is defined as a domestic corporation which is not an ineligible corporation and which does not have (1) more than 35 shareholders, (2) as a shareholder, a person (other than certain trusts or estates) who is not an individual, (3) a nonresident alien as a shareholder, and (4) more than one class of stock. For purposes of the 35-shareholder limitation, a husband and wife are treated as one shareholder.

Description of Proposal

The proposal would increase maximum number of eligible shareholders from 35 to 75.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

The proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995.

2. Permit certain trusts to hold stock in S corporations

Present Law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S trusts" may not be shareholders in a S corporation. A "qualified subchapter S trust" is a trust which, under its terms, (1) is required to have only one current income beneficiary (for life), (2) any corpus distributed during the life of the beneficiary must be distributed to the beneficiary, (3) the beneficiary's income interest must terminate at the earlier of the beneficiary's death or the termination of the trust, and (4) if the trust terminates during the beneficiary's life, the trust assets must be distributed to the beneficiary. All the income (as defined for local law purposes) must be

currently distributed to that beneficiary. The beneficiary is treated as the owner of the portion of the trust consisting of the stock in the S corporation.

Description of Proposal

In general

The proposal would allow stock in an S corporation to be held by certain trusts ("electing small business trusts"). In order to qualify for this treatment, all beneficiaries of the trust must be individuals or estates eligible to be S corporation shareholders, except that charitable organizations may hold contingent remainder interests. No interest in the trust may be acquired by purchase. For this purpose, "purchase" would mean any acquisition of property with a cost basis (determined under sec. 1012). Thus, interests in the trust must be acquired by reason of gift, bequest, etc.

A trust must elect to be treated as an electing small business trust. An election would apply to the taxable year for which made and could be revoked only with the consent of the Secretary of the Treasury or his delegate.

Each potential current beneficiary of the trust would be counted as a shareholder for purposes of the proposed 75 shareholder limitation (or if there were no potential current beneficiaries, the trust would be treated as the shareholder). A potential current income beneficiary would mean any person, with respect to the applicable period, who is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. Where the trust disposes of all the stock in an S corporation, any person who first became so eligible during the 60 days before the disposition would not be treated as a potential current beneficiary.

A qualified subchapter S trust with respect to which an election is in effect and an exempt trust would not be eligible to qualify as an electing small business trust.

Treatment of items relating to S corporation stock

The portion of the trust which consists of stock in one or more S corporations would be treated as a separate trust for purposes of computing the income tax attributable to the S corporation stock held by the trust. The trust would be taxed at the highest individual rate (currently, 39.6 percent) on this portion of the trust's income. The taxable income attributable to this portion includes (1) the items of income, loss, or deduction allocated to it as an S corporation shareholder under the rules of subchapter S, (2) gain or loss from the sale of the S corporation stock, and (3) to the extent provided in regulations, any state or local income taxes and administrative expenses of the trust properly allocable to the S corporation stock. Otherwise allowable capital losses would be allowed only to the extent of capital gains.

In computing the trust's income tax on this portion of the trust, no deduction would be allowed for amounts distributed to beneficiaries, and no deduction or credit would be allowed for any item other than the items described above. This income would not be included in the distributable net income of the trust, and thus would not be included in the beneficiaries' income. No item relating to the S corporation stock could be apportioned to any beneficiary.

On the termination of all or any portion of an electing small business trust the loss carryovers or excess deductions referred to in section 642(h) would be taken into account by the entire trust, subject to the usual rules on termination of the entire trust.

Treatment of remainder of items held by trust

In determining the tax liability with regard to the remaining portion of the trust, the items taken into account by the subchapter S portion of the trust would be disregarded. Although distributions from the trust would be deductible in computing the taxable income on this portion of the trust, under the usual rules of subchapter J, the trust's distributable net income would not include any income attributable to the S corporation stock.

Termination of trust and conforming amendment applicable to all trusts

Where the trust terminates before the end of the S corporation's taxable year, the trust would take into account its pro rata share of S corporation items for its final year. The proposal would make a conforming amendment applicable to all trusts and estates clarifying that this is the present-law treatment of trusts and estates that terminate before the end of the S corporation's taxable year.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995.

A similar provision was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush in 1992, and in H.R. 3419 (103rd Cong.), as passed by the House on May 17, 1994.

3. Extend holding period for certain trusts

Present Law

Under present law, trusts other than grantor trusts, voting trusts, certain testamentary trusts and "qualified subchapter S trusts" may not be shareholders in a S corporation. A grantor trust may remain an S corporation shareholder for 60 days after the death of the grantor. The 60-day period is extended to 2 years if the entire corpus of the trust is includible in the gross estate of the deemed owner. In addition, a trust may be an S corporation shareholder for 60 days after the transfer of S corporation pursuant to a will.

Description of Proposal

The proposal would expand the post-death holding period to 2 years for all testamentary trusts.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal is included in H.R. 2039, introduced by Mr. Shaw and others on July 13, 1995.

4. Financial institutions permitted to hold safe harbor debt

Present Law

A small business corporation eligible to be an S corporation may not have more than one class of stock. Certain debt ("straight debt") is not treated as a second class of stock so long as such debt is an unconditional promise to pay on demand or on a specified date a sum certain in money if: (1) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors; (2) there is no convertibility (directly or indirectly) into stock, and (3) the creditor is an individual (other than a nonresident alien), an estate, or certain qualified trusts.

Description of Proposal

The definition of "straight debt" would be expanded to include debt held by creditors, other than individuals, that are actively and regularly engaged in the business of lending money.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995.

5. Authority to validate certain invalid elections

Present Law

Under present law, if the Internal Revenue Service ("IRS") determines that a corporation's Subchapter S election is inadvertently terminated, the IRS can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and shareholders agree to be treated as if the election had been in effect for that period. Such waivers generally are obtained through the issuance of a private letter ruling. Present law does not grant the IRS the ability to waive the effect of an inadvertent invalid Subchapter S election.

In addition, under present law, a small business corporation must elect to be an S corporation no later than the 15th day of the third month of the taxable year for which the election is effective. The IRS may not validate a late election.

Description of Proposal

Under the proposal, the authority of the IRS to waive the effect of an inadvertent termination would be extended to allow the Service to waive the effect of an invalid election caused by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including elections regarding qualified subchapter S trusts), or both. The proposal also would allow the IRS to treat a late Subchapter S election as timely where the Service determines that there was reasonable cause for the failure to make the election timely.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1982.[1].

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[1] This is the effective date of the present-law provision regarding inadvertent terminations.

Legislative Background

A similar proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995. A similar provision was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush in 1992, and in H.R. 3419 (103rd Cong.), as passed by the House on May 17, 1994.

6. Allow interim closing of the books of termination of shareholder interest with consent of corporation and affected shareholders

Present Law

In general, each item of S corporation income, deduction and loss is allocated to shareholders on a per-share, per-day basis. However, if any shareholder terminates his or her interest in an S corporation during a taxable year, the S corporation, with the consent of all its shareholders, may elect to allocate S corporation items by closing its books as of the date of such termination rather than apply the per-share, per-day rule.

Description of Proposal

The proposal would provide that, under regulations to be prescribed by the Secretary of the Treasury, the election to close the books of the S corporation upon the termination of a shareholder's interest would be made by and apply to, all affected shareholders and the corporation, rather than by all shareholders. The closing of the books would apply to the affected shareholders. For this purpose, "affected shareholders" would mean any shareholder whose interest is terminated and all shareholders to whom such shareholder has transferred shares during the year. If a shareholder transferred shares to the corporation, "affected shareholders" would include all persons who were shareholders during the year.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995.

7. Expand the post-termination period and amend subchapter S audit procedures

Present Law

Distributions made by a former S corporation during its post-termination period are treated in the same manner as if the distributions were made by an S corporation (e.g., treated by shareholders as nontaxable distributions to the extent of the accumulated adjustment account). Distributions made after the post-termination period are generally treated as made by a C corporation (i.e., treated by shareholders as taxable dividends to the extent of earnings and profits).

The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

In addition, the audit procedures adopted by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") with respect to partnerships also apply to S corporations. Thus, the tax treatment of items is determined at the corporate, rather than individual level.

Description of Proposal

The present-law definition of post-termination period would be expanded to include the 120-day period beginning on the date of any determination pursuant to an audit of the taxpayer that follows the termination of the S corporation's election and that adjusts a subchapter S item of income, loss or deduction of the S corporation during the S period. In addition, the definition of "determination" would be expanded to include a final disposition of the Secretary of the Treasury of a claim for refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

In addition, the bill would repeal the TEFRA audit provisions applicable to S corporations and would provide other rules to require consistency between the returns of the S corporation and its shareholders.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995. The provision that repeals the TEFRA audit rules was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush in 1992 and in H.R. 3419 (103rd Cong.), as passed by the House on May 17, 1994.

8. S corporations permitted to hold S or C subsidiaries

Present Law

A small business corporation may not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Thus, an S corporation may not own 80 percent or more of the stock of another corporation (whether an S corporation or a C corporation).

In addition, a small business corporation may not have as a shareholder another corporation (whether an S corporation or a C corporation).

Description of Proposal

C corporation subsidiaries

An S corporation would be allowed to own 80 percent or more of the stock of a C corporation. The C corporation subsidiary could elect to join in the filing of a consolidated return with its affiliated C corporations. An S corporation would not be allowed to join in such election. Dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership stake would not be treated as passive investment income for purposes of section 1375 to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business.

S corporation subsidiaries

In addition, an S corporation would be allowed to own a qualified subchapter S subsidiary. The term "qualified subchapter S subsidiary" would mean a domestic corporation that is not an ineligible corporation (i.e., a corporation that would be eligible to be an S corporation if the stock of the corporation were held directly by the shareholders of its parent S corporation) if (1) 100 percent of the stock of the subsidiary were held by its S corporation parent and (2) for which the parent elects to treat as a qualified subchapter S subsidiary. If a subsidiary ceases to be a qualified S corporation subsidiary (either because the subsidiary fails to qualify or the parent revokes the election) another such election may not be made for the subsidiary by the parent for five years without the consent of the

Secretary of the Treasury.

Under the election, the qualified subchapter S subsidiary would not be treated as a separate corporation and all the assets, liabilities, and items of income deduction, and credit of the subsidiary would be treated as the assets, liabilities, and items of income, deduction, and credit of the parent S corporation. Thus, transactions between the S corporation parent and qualified S corporation subsidiary would not be taken into account and items of the subsidiary (including accumulated earnings and profits, passive investment income, built-in gains, etc.) would be considered to be items of the parent. In addition, if a subsidiary ceases to be a qualified subchapter S subsidiary (e.g., fails to meet the wholly-owned requirement), the subsidiary will be treated as a new corporation acquiring all of its the assets (and assuming all of it liabilities) immediately before such cessation from the parent S corporation in exchange for its stock.[2]

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995. The provision relating to C corporations was included in H.R. 11 (102nd Cong.), as passed by the House and Senate and vetoed by President Bush in 1992, and in H.R. 3419 (103rd Cong.), as passed by the House on May 17, 1994.

9. Treatment of distributions by S corporations during loss year

Present Law

Under present law, the amount of loss an S corporation shareholder may take into account for a taxable year cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the adjusted basis in any indebtedness of the corporation to the shareholder. Any excess loss is carried forward.

Any distribution to a shareholder by an S corporation generally is tax-free to the shareholder to the extent of the shareholder's adjusted basis of his or her stock. The shareholder's adjusted basis is reduced by the tax-free amount of the distribution. Any distribution in excess of the shareholder's adjusted basis is treated as gain from the sale or exchange of property.

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[2] Similar rules apply with respect to wholly owned subsidiaries of real estate investment trusts (REITs) under section 856(i) of present law.

Under present law, income (whether or not taxable) and expenses (whether or not deductible) serve, respectively, to increase and decrease an S corporation shareholder's basis in the stock of the corporation. These rules require that the adjustments to basis for items of both income and loss for any taxable year apply before the adjustment for distributions applies.[3]

These rules limiting losses and allowing tax-free distributions up to the amount of the shareholder's adjusted basis are similar in certain respects to the rules governing the treatment of losses and cash distributions by partnerships. Under the partnership rules (unlike the S corporation rules), for any taxable year, a partner's basis is first increased by items of income, then decreased by distributions, and finally is decreased by losses for that year.[4]

In addition, if the S corporation has accumulated earnings and profits,[5] any distribution in excess of the amount in an "accumulated adjustments account" will be treated as a dividend (to the extent of the accumulated earnings and profits). A dividend distribution does not reduce the adjusted basis of the shareholder's stock. The "accumulated adjustments account" generally is the amount of the accumulated undistributed post-1982 gross income less deductions.

Description of Proposal

The proposal would provide that the adjustments for distributions made by an S corporation during a taxable year are taken into account before applying the loss limitation for the year. Thus, distributions during a year would reduce the adjusted basis for purposes of determining the allowable loss for the year, but the loss for a year would not reduce the adjusted basis for purposes of determining the tax status of the distributions made during that year.

The proposal also would provide that in determining the amount in the accumulated adjustment account for purposes of determining the tax treatment of distributions made during a taxable year by an S corporation having accumulated earnings and profits, net negative adjustments (i.e., the excess of losses and deductions over income) for that taxable year are disregarded.

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[3] See section 1368(d)(1); H. Rept. 97-826, p. 17; S. Rept. 97-640, p. 18; Treas. reg. sec. 1.1367-1(e).

[4] Treas. reg. sec. 1.704-1(d)(2); Rev. Rul. 66-94, 1966-1 C.B. 166.

[5] An S corporation may have earnings and profits from years prior to its subchapter S election or from pre-1983 subchapter S years.

The following examples illustrate the application of these provisions:

Example 1.--X is the sole shareholder of corporation A, a calendar year S corporation with no accumulated earnings and profits. X's adjusted basis in the stock of A on January 1, 1996, is $1,000 and X holds no debt of A. During 1996, A makes a distribution to X of $600, recognizes a capital gain of $200 and sustains an operating loss of $900. Under the bill, X's adjusted basis in the A stock is increased to $1,200 ($1,000 plus $200 capital gain recognized) pursuant to section 1368(d) to determine the effect of the distribution. X's adjusted basis is then reduced by the amount of the distribution to $600 ($1,200 less $600) to determine the application of the loss limitation of section 1366(d)(1). X is allowed to take into account $600 of A's operating loss, which reduces X's adjusted basis to zero. The remaining $300 loss is carried forward pursuant to section 1366(d)(2).

Example 2.--The facts are the same as in Example 1, except that on January 1, 1996, A has accumulated earnings and profits of $500 and an accumulated adjustments account of $200. Under the bill, because there is a net negative adjustment for the year, no adjustment is made to the accumulated adjustments account before determining the effect of the distribution under section 1368(c).

As to A, $200 of the $600 distribution is a distribution of A's accumulated adjustments account, reducing the accumulated adjustments account to zero. The remaining $400 of the distribution is a distribution of accumulated earnings and profits ("E&P") and reduces A's E&P to $100. A's accumulated adjustments account is then increased by $200 to reflect the recognized capital gain and reduced by $900 to reflect the operating loss, leaving a negative balance in the accumulated adjustment account on January 1, 1997, of $700 (zero plus $200 less $900).

As to X, $200 of the distribution is applied against X's adjusted basis of $1,200 ($1,000 plus $200 capital gain recognized), reducing X's adjusted basis to $1,000. The remaining $400 of the distribution is taxable as a dividend and does not reduce X's adjusted basis. Because X's adjusted basis is $1,000, the loss limitation does not apply to X, who may deduct the entire $900 operating loss. X's adjusted basis is then decreased to reflect the $900 operating loss. Accordingly, X's adjusted basis on January 1, 1997, is $100 ($1,000 plus $200 less $200 less $900).

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995. A similar provision was included in H.R. 11 (102nd Cong.), as passed by the

House and Senate and vetoed by President Bush in 1992, and in H.R. 3419 (103rd Cong.), as passed by the House on May 17, 1994.

10. Treatment of S corporations as shareholders in C corporations

Present Law

Present law contains several provisions relating to the treatment of S corporations as corporations generally for purposes of the Internal Revenue Code.

First, under present law, the taxable income of an S corporation is computed in the same manner as in the case of an individual (sec. 1363(b)). Under this rule, the provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction, do not apply to S corporations.

Second, except as otherwise provided by the Internal Revenue Code and except to the extent inconsistent with subchapter S, subchapter C (i.e., the rules relating to corporate distributions and adjustments) applies to an S corporation and its shareholders (sec. 1371(a)(1)). Under this second rule, provisions such as the corporate reorganization provisions apply to S corporations. Thus, a C corporation may merge into an S corporation tax-free.

Finally, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C (sec. 1371(a)(2)). The Internal Revenue Service has taken the position that this rule prevents the tax-free liquidation of a C corporation into an S corporation because a C corporation cannot liquidate tax-free when owned by an individual shareholder.[6] Thus, a C corporation may elect S corporation status tax-free or may merge into an S corporation tax-free, but may not liquidate into an S corporation tax-free.[7] Also, the Service's reasoning would prevent an S corporation from making an election under section 338 where a C corporation was acquired by an S corporation.

Description of Proposal

The proposal would repeal the rule that treats an S corporation in its capacity as a shareholder of another corporation as an individual. Thus, the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules,

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[6] See PLR 8818049, (Feb. 10, 1988). However, see PLR 9245004, (July 28, 1992) for a contrary ruling.

[7] Tax is imposed with respect to LIFO inventory held by a C corporation becoming an S corporation.

including the provisions of sections 332 and 337 allowing the tax-free liquidation of a corporation into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax under section 1374 upon a subsequent disposition. An S corporation also will be eligible to make a section 338 election (assuming all the requirements are otherwise met), resulting in immediate recognition of all the acquired C corporation's gains and losses (and the resulting imposition of a tax).

The repeal of this rule would not change the general rule governing the computation of income of an S corporation. For example, it would not allow an S corporation, or its shareholders, to claim a dividends received deduction with respect to dividends received by the S corporation, or to treat any item of income or deduction in a manner inconsistent with the treatment accorded to individual taxpayers.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995. A similar provision was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush in 1992, and in H.R. 3419 (103rd Cong.), as passed by the House on May 17, 1994.

11. Elimination of certain earnings and profits of S corporations

Present Law

Under present law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect before revision in 1982, a corporation electing subchapter S for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. As a result of this rule, a shareholder may later be required to include in his or her income the accumulated earnings and profits when it is distributed by the corporation. The 1982 revision to subchapter S repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

Description of Proposal

The proposal would provide that if a corporation is an S corporation for its first taxable year beginning after December 31, 1995, the accumulated earnings and profits of

the corporation as of the beginning of that year would reduced by the accumulated earnings and profits (if any) accumulated in any taxable year beginning before January 1, 1983, for which the corporation was an electing small business corporation under subchapter S. Thus, such a corporation's accumulated earnings and profits would be solely attributable to taxable years for which an S election was not in effect. This rule is generally consistent with the change adopted in 1982 limiting the S shareholder's taxable income attributable to S corporation earnings to his or her share of the taxable income of the S corporation.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995. A similar provision was included in H.R. 3419 (103rd Cong.), as passed by the House on May 17, 1994.

12. Treatment of certain losses carried over under the at-risk rules

Present Law

Under section 1366, the amount of loss an S corporation shareholder may take into account cannot exceed the sum of the shareholder's adjusted basis in his or her stock of the corporation and the unadjusted basis in any indebtedness of the corporation to the shareholder. Any disallowed loss is carried forward to the next taxable year. Any loss that is disallowed for the last taxable year of the S corporation may be carried forward to the post-termination period. The "post-termination period" is the period beginning on the day after the last day of the last taxable year of the S corporation and ending on the later of: (1) a date that is one year later, or (2) the due date for filing the return for the last taxable year and the 120-day period beginning on the date of a determination that the corporation's S corporation election had terminated for a previous taxable year.

In addition, under section 465, a shareholder of an S corporation may not deduct losses that are flowed through from the corporation to the extent the shareholder is not "at-risk" with respect to the loss. Any loss not deductible in one taxable year because of the at-risk rules is carried forward to the next taxable year.

Description of Proposal

Losses of an S corporation that are suspended under the at-risk rules of section 465 would be carried forward to the S corporation's post-termination period.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995.

13. Adjustments to basis of inherited S stock to reflect certain items of income in respect to a decedent

Present Law

Income in respect to a decedent ("IRD") generally consists of items of gross income that accrued during the decedent's lifetime but were not includible in the decedent's income before his or her death under his or her method of accounting. IRD is includible in the income of the person acquiring the right to receive such item. A deduction for the estate tax attributable to an item of IRD is allowed to such person (sec. 691(c)). The cost or basis of property acquired from a decedent is its fair market value at the date of death (or alternate valuation date if that date is elected for estate tax purposes). This basis is often referred to as a "stepped-up basis." Property that constitutes a right to receive IRD does not receive a stepped-up basis.

The basis of a partnership interest or corporate stock acquired from a decedent generally is stepped-up at death. Under Treasury regulations, the basis of a partnership interest acquired from a decedent is reduced to the extent that its value is attributable to items constituting IRD (Treas. reg. sec. 1.742-1). This rule insures that the items of IRD held by a partnership are not later offset by a loss arising from a stepped-up basis. Although S corporation income is taxed to its shareholders in a manner similar to the taxation of a partnership and its partners, no comparable regulation requires a reduction in the basis of stock in an S corporation acquired from a decedent where the S corporation holds items of IRD.

Description of Proposal

The proposal would provide that a person acquiring stock in an S corporation from a decedent would treat as IRD his or her pro rata share of any item of income of the corporation that would have been IRD if that item had been acquired directly from the decedent. Where an item is treated as IRD, a deduction for the estate tax attributable to the item generally will be allowed under the provisions of section 691(c). The stepped-up basis in the stock in an S corporation acquired from a decedent would be reduced by the extent to

which the value of the stock is attributable to items consisting of IRD. This basis rule is comparable to the present-law partnership rule.

Effective Date

The proposal would apply with respect to decedents dying after the date of enactment.

Legislative Background

A similar provision was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and, vetoed by President Bush in 1992, and in H.R. 3419, as passed by the House on May 17, 1994.

14. Treatment of certain real estate held by an S corporation

Present Law

Under present-law section 1237, a lot or parcel of land held by a taxpayer other than a corporation generally is not treated as ordinary income property solely by reason of the land being subdivided if (1) such parcel had not previously been held as ordinary income property and if in the year of sale, the taxpayer held no other real property; (2) no substantial improvement has been made on the land by the taxpayer, a related party, a lessee, or a government; and (3) the land has been held by the taxpayer for five years.

Description of Proposal

The proposal would allow the present-law capital gains presumption in the case of land held by an S corporation.

Effective Date

The proposal would be effective for sales in taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal is included in H.R. 1213, introduced by Mr. Stark on March 10, 1995. A similar provision also was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush in 1992.

15. Transition rule for elections after termination

Present Law

A small business corporation that terminates its subchapter S election (whether by revocation or otherwise) may not make another election to be an S corporation for five taxable years unless the Secretary of the Treasury consents to such election.

Description of Proposal

For purposes of the 5-year rule, any termination of subchapter S status in effect immediately before the date of enactment of the proposal would not be taken into account. Thus, any small business corporation that had terminated its S corporation election within the 5 year period before the date of enactment may re-elect subchapter S status upon enactment of the proposal without the consent of the Secretary of the Treasury.

Effective Date

The proposal would be effective upon the date of enactment.

Legislative Background

A similar proposal is included in H. R. 2039, introduced by Mr. Shaw and others on July 13, 1995.

B. Accounting Provisions

1. Modifications to the look-back method for long-term contracts

Present Law

Taxpayers engaged in the production of property under a long-term contract generally must compute income from the contract under the percentage of completion method. Under the percentage of completion method, a taxpayer must include in gross income for any taxable year an amount that is based on the product of (1) the gross contract price and (2) the percentage of the contract completed as of the end of the year. The percentage of the contract completed as of the end of the year is determined by comparing costs incurred with respect to the contract as of the end of the year with estimated total contract costs.

Because the percentage of completion method relies upon estimated, rather than actual, contract price and costs to determine gross income for any taxable year, a "look-back method" is applied in the year a contract is completed in order to compensate the taxpayer (or the Internal Revenue Service) for the acceleration (or deferral) of taxes paid over the contract term. The first step of the look-back method is to reapply the percentage of completion method using actual contract price and costs rather than estimated contract price and costs. The second step generally requires the taxpayer to recompute its tax liability for each year of the contract using gross income as reallocated under the look-back method. If there is any difference between the recomputed tax liability and the tax liability as previously determined for a year, such difference is treated as a hypothetical underpayment or overpayment of tax to which the taxpayer applies a rate of interest equal to the overpayment rate, compounded daily.[1] The taxpayer receives (or pays) interest if the net amount of interest applicable to hypothetical overpayments exceeds (or is less than) the amount of interest applicable to hypothetical underpayments.

The look-back method must be reapplied for any item of income or cost that is properly taken into account after the completion of the contract.

The look-back method does not apply to any contract that is completed within two taxable years of the contract commencement date and if the gross contract price does not exceed the lesser of (1) $1 million or (2) one percent of the average gross receipts of the taxpayer for the preceding three taxable years. In addition, a simplified look-back method is available to certain pass-through entities and, pursuant to Treasury regulations, to certain other taxpayers. Under the simplified look-back method, the hypothetical underpayment or overpayment of tax for a contract

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[1] The overpayment rate equals the applicable Federal short-term rate plus two percentage points. This rate is adjusted quarterly by the IRS. Thus, in applying the look-back method for a contract year, a taxpayer may be required to use five different interest rates.

year generally is determined by applying the highest rate of tax applicable to such taxpayer to the change in gross income as recomputed under the look-back method.

Description of Proposal

Election not to apply the look-back method for de minimis amounts

The proposal would provide that a taxpayer may elect not to apply the look-back method with respect to a long-term contract if for each prior contract year, the cumulative taxable income (or loss) under the contract as determined using estimated contract price and costs is within 10 percent of the cumulative taxable income (or loss) as determined using actual contract price and costs.

Thus, under the election, upon completion of a long-term contract, a taxpayer would be required to apply the first step of the look-back method (the reallocation of gross income using actual, rather than estimated, contract price and costs), but would not be required to apply the additional steps of the look-back method if the application of the first step resulted in de minimis changes to the amount of income previously taken into account for each prior contract year.

The election would apply to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 1.--A taxpayer enters into a three-year contract and upon completion of the contract, determines that annual net income under the contract using actual contract price and costs is $100,000, $150,000, and $250,000, respectively, for Years 1, 2, and 3 under the percentage of completion method. An electing taxpayer need not apply the look-back method to the contract if it had reported cumulative net taxable income under the contract using estimated contract price and costs of between $90,000 and $110,000 as of the end of Year 1; and between $225,000 and $275,000 as of the end of Year 2.

Election not to reapply the look-back method

The proposal would provide that a taxpayer may elect not to reapply the look-back method with respect to a contract if, as of the close of any taxable year after the year the contract is completed, the cumulative taxable income (or loss) under the contract is within 10 percent of the cumulative look-back income (or loss) as of the close of the most recent year in which the look-back method was applied (or would have applied but for the other de minimis exception described above). In applying this rule, amounts that are taken into account after completion of the contract would not be discounted.

Thus, an electing taxpayer need not apply or reapply the look-back method if amounts that are taken into account after the completion of the contract are de minimis.

The election would apply to all long-term contracts completed during the taxable year for which the election is made and to all long-term contracts completed during subsequent taxable years, unless the election is revoked with the consent of the Secretary of the Treasury.

Example 2.--A taxpayer enters into a three-year contract and reports taxable income of $12,250, $15,000 and $12,750, respectively, for Years 1 through 3 with respect to the contract. Upon completion of the contract, cumulative look-back income with respect to the contract is $40,000, and 10 percent of such amount is $4,000. After the completion of the contract, the taxpayer incurs additional costs of $2,500 in each of the next three succeeding years (Years 4, 5, and 6) with respect to the contract. Under the bill, an electing taxpayer does not reapply the look-back method for Year 4 because the cumulative amount of contract taxable income ($37,500) is within 10 percent of contract look-back income as of the completion of the contract ($40,000). However, the look-back method must be applied for Year 5 because the cumulative amount of contract taxable income ($35,000) is not within 10 percent of contract look-back income as of the completion of the contract ($40,000). Finally, the taxpayer does not reapply the look-back method for Year 6 because the cumulative amount of contract taxable income ($32,500) is within 10 percent of contract look-back income as of the last application of the look-back method ($35,000).

Interest rates used for purposes of the look-back method

The proposal would provide that for purposes of the look-back method, only one rate of interest is to apply for each accrual period. An accrual period with respect to a taxable year begins on the day after the return due date (determined without regard to extensions) for the taxable year and ends on such return due date for the following taxable year. The applicable rate of interest is the overpayment rate in effect for the calendar quarter in which the accrual period begins.

Effective Date

The proposal would apply to contracts completed in taxable years ending after the date of enactment.

2. Allow traders to use a mark-to-market method of accounting for securities

Present Law

Methods of accounting, in general

In general, a taxpayer must compute its taxable income under a method of accounting on the basis of which the taxpayer regularly keeps its books so long as, in the opinion of the Secretary of the Treasury, such method clearly reflects the taxpayer's income. A taxpayer may change its method of accounting with the consent of the Secretary.

Dealers in securities

A dealer in securities must compute its income pursuant to a "mark-to-market" method of accounting prescribed by section 475. Under section 475, any security that is inventory in the hands of a dealer must be included in inventory at its fair market value and any security that is that is not inventory in the hands of a dealer and that is held at year end shall be treated as sold for its fair market value. For this purpose, a "dealer in securities" is any person who (1) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (2) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. For this purpose, "security" means any stock in a corporation; any partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; any note, bond, debenture, or other evidence of indebtedness; any interest rate, currency or equity notional principal contract; any evidence of an interest in, or a derivative financial instrument of any security described above; and any position identified as a hedge of any of the above (other than a section 1256(a) contract). Section 475 generally does not apply to any security identified as held for investment (or a hedge of such security). Any gain or loss taken into account under section 475 generally is treated as ordinary gain or loss (sec. 475(d)(3)).

Traders in securities

Traders in securities generally are taxpayers who derive their income principally from the active sale or exchange of securities on the market rather than to customers. Section 475 does not explicitly apply to traders in securities. In fact, there are no specific statutory provisions that mandate the use of an overall method of accounting applicable to traders.[2] Thus, traders generally account for gains and losses on trading securities when the securities are sold, rather than marking the securities to market, for Federal income tax purposes.

Description of Proposal

The proposal would provide that a trader in securities may, with the consent of the Secretary of the Treasury, elect to change its method of accounting to adopt a mark-to-market method for its trading activities. Such method may be based on the provisions of present-law section 475, modified to clearly reflect the income of the taxpayer. The adoption of a mark-to-market method of accounting would not change the character of the gain or loss with respect to the securities (i.e., sec. 475(d)(3) could not apply). As under present law, the accounting method change would be subject to such conditions and procedures as the Secretary of the Treasury may prescribe. For this purpose, a trader in securities would be a taxpayer who is actively engaged in trading securities of the type described in section 475.

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[2] However, under section 1256 certain regulated futures contracts, foreign currency contracts, and nonequity options of traders must be marked to market for Federal income tax purposes.

No inference would be intended whether the Secretary of the Treasury has the authority under present law to allow taxpayers that are not dealers in securities to use a mark-to-market method of accounting.

Effective Date

The proposal would be effective for taxable years ending on or after December 31, 1995.

Legislative Background

Section 475 was included in the Omnibus Budget Reconciliation Act of 1993.

3. Modification of Treasury ruling requirement for nuclear decommissioning funds

Present Law

Under the economic performance rules, a deduction for accrual basis taxpayers generally is deferred until there is economic performance for the item for which the deduction is claimed. Present law contains an exception to the economic performance rules under which a taxpayer responsible for nuclear power plant decommissioning may elect to deduct contributions made to a qualified nuclear decommissioning fund.[3] Taxpayer who do not elect this provision are subject to the general economic performance rules.

A qualified decommissioning fund is a segregated fund established by the taxpayer that is used exclusively for the payment of decommissioning costs, taxes on fund income, payment of management costs of the fund, and investment is certain types of investments. The fund is prohibited from dealing with the taxpayer that established the fund.

Contributions to the fund are deductible in the year made to the extent that these amounts were collected as part of the cost of service to rate payers. Withdrawal of funds by the taxpayer to pay for decommissioning expenses are included in income at that time, but the taxpayer also is entitled to a deduction at that time for decommissioning expenses as economic performance for those costs occurs.

In order to prevent accumulations of funds over the remaining life of the plant in excess of those required to pay future decommissioning costs and to ensure that contributions to the funds

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[3] As originally enacted in 1984, the fund paid tax on its earnings at the top corporate rate and, as a result, there would be no present value tax benefit of making deductible contributions to the fund. Also, as originally enacted, the funds in the trust could be invested only in certain relatively safe investments. Subsequent amendments to the provision have reduced the rate of tax on the fund to 20 percent and removed the restrictions on the types of permitted investment that the fund can make.

are not deducted more rapidly than level funding, taxpayers are required to obtain a ruling from the IRS to establish the maximum contribution that may be made to the fund. The IRS is directed to review the ruling amount at least once during the plant's life, but may do more frequently at the request of the taxpayer. The existing Treasury regulations provide that there is one required request per reactor, even where there are sites on which there are multiple reactors. Changes in the initial ruling amount may be warranted as a result of changes in the estimated cost of decommissioning a reactor, changes on the investment return on assets held in the fund, or changes brought about by ratemaking procedures. Taxpayers generally request subsequent rulings to reflect these changes.

If the decommissioning fund fails to comply with the qualification requirements or when the decommissioning is substantially completed, the fund's qualification may be terminated in which case the amounts in the fund must be included in income of the taxpayer.

Description of Proposal

The proposal would delete the requirement that a taxpayer obtain certain rulings from the IRS in order to deduct contributions to a nuclear decommissioning fund. Under the proposal, a taxpayer would be required to obtain an initial ruling to determine its maximum deduction for contributions to a fund, but would not be required to obtain subsequent rulings if such amounts are not substantially modified. The taxpayer would be required to notify the Secretary of the Treasury if the ruling amount is modified.

Effective Date

The proposal would apply to modifications after the date of enactment.

4. Treatment of certain crop insurance proceeds and disaster assistance payments

Present Law

A taxpayer engaged in a farming business generally may use the cash receipts and disbursements method of accounting ("cash method") to report taxable income. A cash method taxpayer generally recognizes income in the taxable year in which cash is received, regardless of when the economic events that give rise to such income occur. Under a special rule (sec. 451(d) of the Internal Revenue Code), in the case of insurance proceeds received as a result of destruction or damage to crops, a cash method taxpayer may elect to defer the income recognition of the proceeds until the taxable year following the year of the destruction or damage, if the taxpayer establishes that under his practice, income from such crops would have been reported in a following taxable year. For this purpose, certain payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988, are treated as insurance proceeds received as a result of destruction or damage to crops.

Description of Proposal

The proposal would amend the special rule of section 451(d) to allow a cash method taxpayer to elect to accelerate (or defer) the recognition of certain disaster-related payments if the taxpayer establishes that, under the taxpayer's practice, income from the crops lost in the disaster would have been accelerated (or deferred). The bill also would expand the payments for which these elections are available to include disaster assistance received as a result of destruction or damage to crops caused by drought, flood, or other natural disaster, or the inability to plant crops because of such a disaster, under any Federal law (rather than only payments received under the Agricultural Act of 1949, as amended, or title II of the Disaster Assistance Act of 1988).

Thus, for example, the proposal would allow a calendar-year, cash method taxpayer who has received disaster assistance payments in 1997 relating to the destruction of crops by a flood in 1996 to elect to treat such payments as received in 1996, so long as the taxpayer establishes that, under the taxpayer's practice, income from such crops would have been reported in 1996. Without the benefit of the proposal, the income of such a taxpayer would be "bunched" in 1997, possibly resulting in the loss of itemized deductions in 1996, a higher marginal income tax rate in 1997, and the loss of AGI-based deductions and exemptions in 1997.

Effective Date

The proposal would be effective for payments received after December 31, 1995, as a result of destruction or damage occurring after such date.

Legislative Background

A similar provision was included in H.R. 1408, as introduced by Mr. Minge on April 5, 1995.

5. Fiscal year election for partnerships and S corporations

Present Law

The taxable income of a partnership or an S corporation (a "flow-thru entity") generally is reported by the partnership's partners or the corporation's shareholders (the "owners") in the taxable year within which the taxable year of the flow-thru entity ends. As a result, if a flow-thru entity uses a taxable year that is the same as the taxable year of its owners, the owners will report income earned by the entity in the year that the income is earned. If a flow-thru entity uses a taxable year that is different than the taxable year of its owners, the owners will defer reporting a portion of the income earned by the entity until the year following the year the income was earned.[4] Thus, in order to avoid

[4] For example, assume that an individual using a calendar year wholly owns the stock of an S corporation using a fiscal year ending January 31. If for its fiscal year beginning February 1, 1994, and ending January 31, 1995, the corporation earned $1,000 a month, the individual would

this deferral, under present law, a flow-through entity generally must use a taxable year that corresponds to the taxable years of its owners (i.e., generally, the calendar year in the case of an entity owned by individuals).

However, under certain circumstances, deferral through use of a fiscal year is permitted (sec. 444). A flow-thru entity may use a fiscal year that it used prior to 1987 or a fiscal year that provides up to a 3-month deferral so long as it makes a payment equal to the income attributable to the deferral period times the highest individual tax rate plus 1 percentage point (currently, 40.6 percent). Such payments remain on deposit and may be refunded if the income of the entity for the deferral period diminishes or the entity abandons its fiscal year (sec. 7519). Under Treasury regulations, the payment described above is not required for a fiscal year for which the entity establishes a business purpose to the satisfaction of the IRS (Treas. Reg. sec. 1.444-1T(a)(3)(i)).

The due date for the tax return of a partnership is the 15th day of the fourth month following the taxpayer's yearend. The due date for the tax return of an S corporation is the 15th day of the third month following the taxpayer's yearend. Thus, to the extent flow-thru entities are required to use the calendar year and do no elect fiscal years, the unextended due dates of the tax returns of flow-thru entities and individuals all fall between March 15th and April 15th of the year.

Description of Proposal

Estimated tax payments by flow-thru entities

The proposal would allow any flow-thru entity to use any fiscal year so long as the entity makes quarterly estimated tax payments at an "applicable rate." These estimated tax payments would be treated as estimated tax payments of the owners of the flow-thru entity for the owners' taxable year in which fiscal year ends. Quarterly installments would be due on the 15th day of the 3rd, 5th, 8th, and 12th months of the taxable year. An election to make quarterly estimated tax payments must be made on before the 15th day of the 3rd month of the first taxable year of 12 months under the election. Such election generally would remain in effect until (1) it is revoked by owners of more than half of the equity interests of the entity, (2) there is a termination of the partnership or the subchapter S election of the corporation, or (3) the entity becomes part of a tiered structure of entities with different fiscal years. An entity would not be allowed to re-elect the provisions of the proposal until five years after the termination of an election without the consent of the Secretary of the Treasury. Estimated tax payments would not be required for a taxable year if the amount of aggregate payments otherwise due was $5,000 or less.

In determining its estimated tax payments, the flow-thru entity would use an applicable rate of 34 percent, unless the flow-thru entity is a "high income average entity," in which case the applicable rate would be 39.6 percent. A "high average income entity" is one where the average

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report the $12,000 of aggregate corporate income in his calendar year ending December 31, 1995, even though $11,000 had been earned by the corporation during 1994.

applicable income of the 2-percent owners for the base year was at least $250,000, or in the case of a partnership, the applicable income for the base year was at least $10,000,000. For this purpose, a "2-percent owner" would be (1) in the case of a partnership, any person who owns (or would be considered as owning within the meaning of the attribution rules of sec. 318) on any day during the base year, more than 2 percent of the capital interest of the partnership, and (2) in the case of an S corporation, any shareholder who owns (or would be considered as owning within the meaning of the attribution rules of sec. 318) on any day of the taxable year, more than 2 percent of the outstanding stock of the corporation or more than 2 percent of the outstanding voting stock of the corporation. For this purpose, the "base year" would be the most recent prior taxable year containing 12 months.

In determining quarterly estimated tax payments, the entity may use (1) the 110-percent method, (2) the 100-percent method, or (3) the annualization method. Under the 110-percent method, the required quarterly installment is one-quarter of 110 percent of the product of the entity's applicable income for the base year and the applicable rate. For this purpose, the "base year" would be the most recent prior taxable year containing 12 months. The 110-percent method would be unavailable if the entity's current year applicable income exceeds its base year applicable income by more than $750,000, or if the entity uses the 100-percent method or the annualization method. Under the 100-percent method, the required quarterly installment is one-quarter of the product of the entity's applicable income for the current year and the applicable rate. Under the annualization method, the required quarterly installment is one-quarter of the product of the entity's annualized applicable income and the applicable rate. The amount of the quarterly installment may be increased or decreased to the extent prior installments were overpaid or underpaid under the annualization method. The entity may elect the annualization method for any quarter on or before the due date for such quarter and once selected, must be applied for the remainder of the taxable year.

For this purpose, "applicable income" would be determined by taking the entity's items into account under subchapter K or S, as the case may be, with the following adjustments: (1) charitable contributions and foreign taxes would be deducted, (2) various limitations determined on the partner or shareholder level would be disregarded, (3) guaranteed payments to partners would not be deductible; and (4) no deduction would be allowed for disproportionate deferral period applicable payments. For this purpose, "disproportionate deferral period applicable payments" means the excess (if any) of (1) the product of the deferral ratio and the aggregate applicable payments made to owners during the taxable year, over (2) the aggregate applicable payments made to owners during the deferral period. For this purpose, (1) "applicable payments" would mean amounts paid by the entity that are includible in the income of the owner (except for gains on the sale of property between the entity and the owner or dividends paid by an S corporation), (2) "deferral period" means the months in the period beginning with the entity's taxable year and ending on December 31, and (3) "deferral ratio" means the number of months in the deferral period to the number of months in the taxable year.

If, by reason of the election, the entity has a short taxable year (i.e., a taxable year of less than 12 months), the entity would be required to make an additional estimated tax payment on or before the due date of the election. Such additional tax payment would be determined and treated in a

manner similar to the determination and treatment of other estimated tax payments under the proposal. Any net operating loss arising in such short year would be spread ratably over three taxable years, beginning with the short year (unless the entity is a new entity).

Underpayments of estimated tax

If a flow-thru entity has an underpayment of estimated tax as provided by the proposal, the entity would be subject to an addition to tax determined by applying the underpayment rate established under section 6621 to the amount of the underpayment over the period of the underpayment. The period of the underpayment would run from the due date of the installment until the earlier of the date the entity pays the underpayment or the first April 15 more than 3 months after the close of the entity's taxable year. In addition, if, on the first April 15 more than 3 months after the close of the entity's taxable year, the entity has an underpayment of estimated tax, and the aggregate deposits made by the entity are less than the aggregate amount of allocable shares of estimated tax shown on the entity's return for the year, such shortfall would be treated as a tax on the entity due on such April 15 (unless the owners had paid such shortfall). If the entity has an excess of deposits, such excess would be treated as an overpayment of tax by the entity.

Credit to owners for estimated tax

An owner's allocable share of estimated tax paid by a flow-thru entity would be allowed as a credit ("estimated tax credit") against the owner's tax liability for the first taxable year ending with or after the close of the entity's taxable year. An owner's allocable share of estimated tax paid by a flow-thru entity would be the determined by applying the ratio of the owner's applicable income for the year to the aggregate applicable income for all owners for the year to the aggregate estimate tax payments made by the entity during the taxable year. In the case of an entity that uses the annualization method, this determination would be made on an quarterly basis.

An owner generally would treat the estimated tax credit as being incurred ratably throughout the owner's taxable year. However, if the flow-thru entity uses the annualization method for any quarter, the estimated tax credit would be deemed to flow through to the owner in the same pattern as such payments were made by the flow-thru entity.

Treatment of current elections

A new flow-thru entity would not be allowed to make an election under present-law section 444. An entity that currently has section 444 election in effect may (1) retain the election, or (2) revoke the election and receive a refund of its deposit or credit its deposit as payment of estimated tax under the proposal.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1996.

Legislative Background

The Tax Reform Act of 1986 restricted the use of fiscal years by flow-thru entities. The Revenue Act of 1987 instituted present-law sections 444 and 7519. H.R. 11, as passed by the House and the Senate and vetoed by President Bush in 1992, would have expanded sections 444 and 7519 by providing that any flow-thru entity could use any fiscal year so long as it made a deposit equal to the highest rate plus 2 percentage points.

A similar provision was included in H.R. 1661 as introduced by Mr. Shaw on May 17, 1995.

C. Provisions Relating to Regulated Investment Companies ("RICs") and Real Estate Investment Trusts ("REITs")

1. Repeal of 30-percent gross income limitation for RICs

Present Law

A regulated investment company ("RIC") is treated, in essence, as a conduit for Federal income tax purposes. If a corporation qualifies as a RIC, it is allowed a deduction for dividends paid (or deemed paid) to its shareholders. Thus, no corporate level tax is payable on earnings of a RIC distributed (or deemed distributed) to its shareholders.

In order for a corporation to qualify as a RIC, a corporation must elect such status and must satisfy certain tests. In particular, a corporation must derive less than 30 percent of its gross income from the sale or disposition of certain investments (including stock, securities, options, futures, and forward contracts) held less than three months (the "short-short test").

Description of Proposal

The proposal would repeal the short-short test.

Effective Date

The proposal would be effective for taxable years ending after the date of enactment.

Legislative Background

The proposal was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate and vetoed by President Bush in 1992. The proposal also was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994.

2. Provisions relating to REITs

Present Law

Overview

In general, a real estate investment trust ("REIT") is an entity that receives most of its income from passive real estate related investments and that receives conduit treatment for income that is distributed to shareholders. If an entity meets the qualifications for REIT status, the portion of its income that is distributed to the investors each year generally is taxed to the investors without being subjected to a tax at the REIT level; the REIT generally is subject to a corporate tax only on the income that it retains and on certain income from property that qualifies

as foreclosure property. Thus, the REIT may serve as a means whereby numerous small investors can have a practical opportunity to invest in a diversified portfolio of real estate assets and have the benefit of professional management.

Election to be Treated as a REIT

In order to qualify as a REIT, and thereby receive conduit treatment, an entity must elect REIT status. A newly-electing entity generally cannot have earnings and profits accumulated from any year in which the entity was in existence and not treated as a REIT (sec. 857(a)(3)). To satisfy this requirement, the entity must distribute, during its first REIT taxable year, any earnings and profits that were accumulated in non-REIT years. For this purpose, distributions by the entity generally are treated as being made from the most recently accumulated earnings and profits.

Taxation of REITs

Overview

In general, if an entity qualifies as a REIT by satisfying the various requirements described below, the entity is taxable as a corporation on its "real estate investment trust taxable income" ("REITTI"), and also is taxable on certain other amounts (sec. 857). REITTI is the taxable income of the REIT with certain adjustments (sec. 857(b)(2)). The most significant adjustment is a deduction for dividends paid. The allowance of this deduction is the mechanism by which the REIT becomes a conduit for income tax purposes.

Capital gains

A REIT that has a net capital gain for a taxable year generally is subject to tax on such capital gain under the capital gains tax regime generally applicable to corporations (sec. 857(b)(3)). However, a REIT may diminish or eliminate its tax liability attributable to such capital gain by paying a "capital gain dividend" to its shareholders (sec. 857(b)(3)(C)). A capital gain dividend is any dividend or part of a dividend that is designated by the payor REIT as a capital gain dividend in a written notice mailed to shareholders. Shareholders who receive capital gain dividends treat the amount of such dividends as long-term capital gain regardless of their holding period of the stock (sec. 857(b)(3)(C)).

A regulated investment company ("RIC"), but not a REIT, may elect to retain and pay income tax on net long-term capital gains it received during the tax year. If a RIC makes this election, the RIC shareholders must include in their income as long-term capital gains their proportionate share of these undistributed long-term capital gains as designated by the RIC. The shareholder is deemed to have paid the shareholder's share of the tax, which can be credited or refunded to the shareholder. Also, the basis of the shareholder's shares is increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the RIC) included in the shareholder's long-term capital gains.

Income from foreclosure property

In addition to tax on its REITTI, a REIT is subject to tax at the highest rate of tax paid by corporations on its net income from foreclosure property (sec. 857(b)(4)). Net income from foreclosure property is the excess of the sum of gains from foreclosure property that is held for sale to customers in the ordinary course of a trade or business and gross income from foreclosure property (other than income that otherwise would qualify under the 75-percent income test described below) over all allowable deductions directly connected with the production of such income.

Foreclosure property is any real property or personal property incident to such real property that is acquired by a REIT as a result of default or imminent default on a lease of such property or indebtedness secured by such property, provided that (unless acquired as foreclosure property), such property was not held by the REIT for sale to customers (sec. 856(e)). A property generally may be treated as foreclosure property for a period of two years after the date the property is acquired by the REIT. The IRS may grant extensions of the period for treating the property as foreclosure property if the REIT establishes that an extension of the grace period is necessary for the orderly liquidation of the REIT's interest in the property. The grace period cannot be extended beyond 6 years from the date the property is acquired by the REIT.

Property will cease to be treated as foreclosure property if, after 90 days after the date of acquisition, the REIT operates the foreclosure property in a trade or business other than through an independent contractor from whom the REIT does not derive or receive any income (sec. 856(e)(4)(C)).

Income or loss from prohibited transactions

In general, a REIT must derive its income from passive sources and not engage in any active trade or business. Accordingly, in addition to the tax on its REITTI and on its net income from foreclosure property, a 100 percent tax is imposed on the net income of a REIT from "prohibited transactions" (sec. 857(b)(6)). A prohibited transaction is the sale or other disposition of property described in section 1221(1) of the Code (property held for sale in the ordinary course of a trade or business) other than foreclosure property. Thus, the 100 percent tax on prohibited transactions helps to ensure that the REIT is a passive entity and may not engage in ordinary retailing activities such as sales to customers of condominium units or subdivided lots in a development project. A safe harbor is provided for certain sales that otherwise might be considered prohibited transactions (sec. 857(b)(6)(C)). The safe harbor is limited to seven or fewer sales a year or, alternatively, any number of sales provided that the aggregate adjusted basis of the property sold does not exceed 10 percent of the aggregate basis of all the REIT's assets at the beginning of the REIT's taxable year.

Requirements for REIT Status

A REIT must satisfy four tests on a year-by-year basis: organizational structure, source of income, nature of assets, and distribution of income. These tests are intended to allow conduit treatment in circumstances in which a corporate tax otherwise would be imposed, only if there really is a pooling of investment arrangement that is evidenced by its organizational structure, if its investments are basically in real estate assets, and if its income is passive income from real estate investment, as contrasted with income from the operation of business involving real estate. In addition, substantially all of the entity's income must be passed through to its shareholders on a current basis.

Organizational structure requirements

To qualify as a REIT, an entity must be for its entire taxable year a corporation or an unincorporated trust or association that would be taxable as a domestic corporation but for the REIT provisions, and must be managed by one or more trustees (sec. 856(a)). The beneficial ownership of the entity must be evidenced by transferable shares or certificates of ownership. Except for the first taxable year for which an entity elects to be a REIT, the beneficial ownership of the entity must be held by 100 or more persons, and the entity may not be so closely held by individuals that it would be treated as a personal holding company if all its adjusted gross income constituted personal holding company income. A REIT is disqualified for any year in which it does not comply with regulations to ascertain the actual ownership of the REIT's outstanding shares.

Income requirements

Overview

In order for an entity to qualify as a REIT, at least 95 percent of its gross income generally must be derived from certain passive sources (the "95-percent test"). In addition, at least 75 percent of its income generally must be from certain real estate sources (the "75-percent test"), including rents from real property.

In addition, less than 30 percent of the entity's gross income may be derived from gain from the sale or other disposition of stock or securities held for less than one year, real property held less than four years (other than foreclosure property, or property subject to an involuntary conversion within the meaning of sec. 1033), and property that is sold or disposed of in a prohibited transaction (sec. 856(c)(4)).

Definition of rents

For purposes of the income requirements, rents from real property generally include rents from interests in real property, charges for services customarily rendered or furnished in

connection with the rental of real property, whether or not such charges are separately stated, and rent attributable to personal property that is leased under or in connection with a lease of real property, but only if the rent attributable to such personal property does not exceed 15 percent of the total rent for the year under the lease (sec. 856(d)(1)).

Services provided to tenants are regarded as customary if, in the geographic market within which the building is located, tenants in buildings that are of a similar class (for example, luxury apartment buildings) are customarily provided with the service. The furnishing of water, heat, light, and air conditioning, the cleaning of windows, public entrances, exits, and lobbies, the performance of general maintenance, and of janitorial and cleaning services, the collection of trash, the furnishing of elevator services, telephone answering services, incidental storage space, laundry equipment, watchman or guard service, parking facilities and swimming pool facilities are examples of services that are customarily furnished to tenants of a particular class of buildings in many geographical marketing areas (Treas. Reg. sec. 1.856-4(b)).

In addition, amounts are not treated as qualifying rent if received from certain parties in which the REIT has an ownership interest of 10 percent or more (sec. 856(d)(2)(B)). For purposes of determining the REIT's ownership interest in a tenant, the attribution rules of section 318 apply, except that 10 percent is substituted for 50 percent where it appears in subparagraph (C) of section 318(a)(2) and 318(a)(3) (sec. 856(d)(5)).

Finally, where a REIT furnishes or renders services to the tenants of rented property, amounts received or accrued with respect to such property generally are not treated as qualifying rents unless the services are furnished through an independent contractor (sec. 856(d)(2)(C)). A REIT may furnish or render a service directly, however, if the service would not generate unrelated business taxable income under section 512(b)(3) if provided by an organization described in section 511(a)(2). In general, an independent contractor is a person who does not own more than a 35 percent interest in the REIT, and in which no more than a 35 percent interest is held by persons with a 35 percent or greater interest in the REIT (sec. 856(d)(3)).

Hedging instruments

Interest rate swaps or cap agreements that protect a REIT from interest rate fluctuations on variable rate debt incurred to acquire or carry real property are treated as securities under the 30-percent test and payments under these agreements are treated as qualifying under the 95-percent test (sec. 856(c)(6)(G)).

Treatment of shared appreciation mortgages

For purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transaction provisions, any income derived from a "shared appreciation provision" is treated as gain recognized on the sale of the "secured property." For these purposes, a shared appreciation provision is any provision that is in connection with an obligation that is held by the

REIT and secured by an interest in real property, which provision entitles the REIT to receive a specified portion of any gain realized on the sale or exchange of such real property (or of any gain that would be realized if the property were sold on a specified date). Secured property for these purposes means the real property that secures the obligation that has the shared appreciation provision.

In addition, for purposes of the income requirements for qualification as a REIT, and for purposes of the prohibited transactions provisions, the REIT is treated as holding the secured property for the period during which it held the shared appreciation provision (or, if shorter, the period during which the secured property was held by the person holding such property), and the secured property is treated as property described in section 1221(1) if it is such property in the hands of the obligor on the obligation to which the shared appreciation provision relates (or if it would be such property if held by the REIT). For purposes of the prohibited transaction safe harbor, the REIT is treated as having sold the secured property at the time that it recognizes income on account of the shared appreciation provision, and any expenditures made by the holder of the secured property are treated as made by the REIT.

Asset requirements

To satisfy the asset requirements to qualify for treatment as a REIT, at the close of each quarter of its taxable year, an entity must have at least 75 percent of the value of its assets invested in real estate assets, cash and cash items, and Government securities (sec. 856(c)(5)(A)). Moreover, not more than 25 percent of the value of the entity's assets can be invested in securities of any one issuer (other than Government securities and other securities described in the preceding sentence). Further, these securities may not comprise more than five percent of the entity's assets or more than 10 percent of the outstanding voting securities of such issuer (sec. 856(c)(5)(B)). The term real estate assets is defined to mean real property (including interests in real property and mortgages on real property) and interests in REITs (sec. 856(c)(6)(B)).

REIT subsidiaries

Under present law, all the assets, liabilities, and items of income, deduction, and credit of a "qualified REIT subsidiary" are treated as the assets, liabilities, and respective items of the REIT that owns the stock of the qualified REIT subsidiary. A subsidiary of a REIT is a qualified REIT subsidiary if and only if 100 percent of the subsidiary's stock is owned by the REIT at all times that the subsidiary is in existence. If at any time the REIT ceases to own 100 percent of the stock of the subsidiary, or if the REIT ceases to qualify for (or revokes an election of) REIT status, such subsidiary is treated as a new corporation that acquired all of its assets in exchange for its stock (and assumption of liabilities) immediately before the time that the REIT ceased to own 100 percent of the subsidiary's stock, or ceased to be a REIT as the case may be.

Distribution requirements

To satisfy the distribution requirement, a REIT must distribute as dividends to its shareholders during the taxable year an amount equal to or exceeding (i) the sum of 95 percent of its REITTI other than net capital gain income and 95 percent of the excess of its net income from foreclosure property over the tax imposed on that income minus (ii) certain excess noncash income (described below).

Excess noncash items include (a) the excess of the amounts that the REIT is required to include in income under section 467 with respect to certain rental agreements involving deferred rents, over the amounts that the REIT otherwise would recognize under its regular method of accounting, (2) in the case of a REIT using the cash method of accounting, the excess of the amount of original issue discount and coupon interest that the REIT is required to take into account with respect to a loan to which section 1274 applies, over the amount of money and fair market value of other property received with respect to the loan, and (3) income arising from the disposition of a real estate asset in certain transactions that failed to qualify as like-kind exchanges under section 1031.

Description of Proposals

Overview

The proposal would modify many of the provisions relating to the requirements for qualification as, and the taxation of, a REIT. In particular, the modifications would relate to the general requirements for qualification as a REIT, the taxation of a REIT, the income requirements for qualification as a REIT, and certain other provisions.

Election to be treated as a REIT

The proposal would change the ordering rule for purposes of the requirement that newly-electing REITs distribute earnings and profits that were accumulated in non-REIT years. Under the proposal, distributions of accumulated earnings and profits generally would be treated as made from the entity's earliest accumulated earnings and profits, rather than the most recently accumulated earnings and profits. These distributions would not be treated as distributions for purposes of calculating the dividends paid deduction.

Taxation of REITs

Capital gains

The proposal would permit a REIT to elect to retain and pay income tax on net long-term capital gains it received during the tax year, just as a RIC is permitted under present law. Thus, if a REIT made this election, the REIT shareholders would include in their income as long-term

capital gains their proportionate share of the undistributed long-term capital gains as designated by the REIT. The shareholder would be deemed to have paid the shareholder's share of the tax, which could be credited or refunded to the shareholder. Also, the basis of the shareholder's shares would be increased by the amount of the undistributed long-term capital gains (less the amount of capital gains tax paid by the REIT) included in the shareholder's long-term capital gains.

Income from foreclosure property

The proposal would lengthen the original grace period for foreclosure property until the last day of the third full taxable year following the election. The grace period also could be extended for an additional three years by filing a request to the IRS. Under the proposal, a REIT could revoke an election to treat property as foreclosure property for any taxable year by filing a revocation on or before its due date for filing its tax return.

In addition, the proposal would conform the definition of independent contractor for purposes of the foreclosure property rule (sec. 856(e)(4)(C)) to the definition of independent contractor for purposes of the general rules (sec. 856(d)(2)(C)).

Income or loss from prohibited transactions

The proposal also would exclude property that was involuntarily converted from the prohibited sales rules.

Organizational structure requirements

The proposal would replace the rule that disqualifies a REIT for any year in which the REIT failed to comply with regulations to ascertain its ownership, with an intermediate penalty for failing to do so. The penalty would be $25,000 ($50,000 for intentional violations) for any year in which the REIT did not comply with the ownership regulations. The REIT also would be required, when requested by the IRS, to send curative demand letters.

In addition, a REIT that complied with the regulations for ascertaining its ownership, and which did not know, or have reason to know, that it was so closely held as to be classified as a personal holding company, would not be treated as a personal holding company.

Income requirements

Overview

The proposal would repeal the rule that requires less than 30 percent of a REIT's gross income be derived from gain from the sale or other disposition of stock or securities held for less than 1 year, certain real property held less than four years, and property that is sold or disposed of in a prohibited transaction.

Definition of rents

The proposal would permit a REIT to render a de minimis amount of impermissible services to tenants, or in connection with the management of property, and still treat amounts received with respect to that property as rent. The value of the impermissible services could not exceed 1 percent of the gross income from the property. For these purposes, the services could not be valued at less than 150 percent of the REIT's direct cost of the services.

In addition, the proposal would modify the application of section 318(a)(3)(A) (attribution to partnerships) for purposes of defining rent in section 856(d)(2), so that attribution would occur only when a partner owns a 25 percent or greater interest in the partnership.

Hedging instruments

The proposal would treat income from all hedges that reduce the interest rate risk of REIT liabilities, not just from interest rate swaps and caps, as qualifying income under the 95-percent test. Thus, payments to a REIT under an interest rate swap, cap agreement, option, futures contract, forward rate agreement or any similar financial instrument entered into by the REIT to hedge its indebtedness incurred or to be incurred (and any gain from the sale or other disposition of these instruments) would be treated as qualifying income for purposes of the 95-percent test.

Asset requirements

REIT subsidiaries

The proposal would permit any wholly-owned corporation of a REIT to be treated as a qualified subsidiary, regardless of whether the corporation had always been owned by the REIT. The proposal would treat any such subsidiary as being liquidated as of the time of acquisition by the REIT and then reincorporated (thus, any of the subsidiary's pre-REIT built-in gain would be subject to tax under the normal rules of section 337). In addition, any pre-REIT earnings and profits of the subsidiary must be distributed before the end of the REIT's taxable year.

Distribution requirements

The proposal would (1) expand the class of excess noncash items to include income from the cancellation of indebtedness and (2) extend the treatment of original issue discount and coupon interest as excess noncash items to REITs that use an accrual method of taxation.

Effective Date

The proposals would be effective for taxable years beginning after the date of enactment.

Legislative Background

Many of the proposals were contained in legislation introduced as H.R. 2121 by Mr. Shaw and others on July 26, 1995.

D. Tax-Exempt Bond Provisions

Overview

Interest on State and local government bonds generally is excluded from gross income for purposes of the regular individual and corporate income taxes if the proceeds of the bonds are used to finance direct activities of these governmental units (Code sec. 103).

Unlike the interest on governmental bonds, interest on private activity bonds generally is taxable. A private activity bond is a bond issued by a State or local governmental unit acting as a conduit to provide financing for private parties in a manner violating either (1) a private business use and payment test or (2) a private loan restriction. However, interest on private activity bonds is not taxable if (1) the financed activity is specified in the Code and (2) at least 95 percent of the net proceeds of the bond issue is used to finance the specified activity.

Issuers of State and local government bonds must satisfy numerous other requirements, including arbitrage restrictions (for all such bonds) and annual State volume limitations (for most private activity bonds) for the interest on these bonds to be excluded from gross income.

1. Repeal of $100,000 limitation on unspent proceeds under 1-year exception from rebate

Present Law

Subject to limited exceptions, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. No rebate is required if the gross proceeds of an issue are spent for the governmental purpose of the borrowing within six months after issuance.

This six-month exception is deemed to be satisfied by issuers of governmental bonds (other than tax and revenue anticipation notes) and qualified 501(c)(3) bonds if (1) all proceeds other than an amount not exceeding the lesser of five percent or $100,000 are so spent within six months and (2) the remaining proceeds are spent within one year after the bonds are issued.

Description of Proposal

The $100,000 limit on proceeds that may remain unspent after six months for certain governmental and qualified 501(c)(3) bonds otherwise exempt from the rebate requirement would be deleted. Thus, if at least 95 percent of the proceeds of these bonds is spent within six months after their issuance, and the remainder is spent within one year, the six-month exception would be deemed to be satisfied.

Effective Date

The proposal would apply to bonds issued after the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

2. Exception from rebate for earnings on bona fide debt service fund under construction bond rules

Present Law

In general, arbitrage profits from investing bond proceeds in investments unrelated to the governmental purpose of the borrowing must be rebated to the Federal Government. An exception is provided for certain construction bond issues if the bonds are governmental bonds, qualified 501(c)(3) bonds, or exempt-facility private activity bonds for governmentally-owned property.

This exception is satisfied only if the available construction proceeds of the issue are spent at minimum specified rates during the 24-month period after the bonds are issued. The exception does not apply to bond proceeds invested after the 24-month expenditure period as part of a reasonably required reserve or replacement fund, a bona fide debt service fund, or to certain other investments (e.g., sinking funds). Issuers of these construction bonds also may elect to comply with a penalty regime in lieu of rebating arbitrage profits if they fail to satisfy the exception's spending requirements.

Description of Proposal

The proposal would exempt earnings on bond proceeds invested in bona fide debt service funds from the arbitrage rebate requirement and the penalty requirement of the 24-month exception if the spending requirements of that exception are otherwise satisfied.

Effective Date

The proposal would apply to bonds issued after the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

3. Repeal of debt service-based limitation on investment in certain nonpurpose investments

Present Law

Issuers of all tax-exempt bonds generally are subject to two sets of arbitrage restrictions on investment of their bond proceeds. The first set requires that tax-exempt bond proceeds be invested at a yield that is not materially higher (generally defined as 0.125 percentage points) than the bond yield. Exceptions are provided to this restriction for investments during any of several "temporary periods" pending use of the proceeds and, throughout the term of the issue, for proceeds invested as part of a reasonably required reserve or replacement fund or a "minor" portion of the issue proceeds.

Except for temporary periods and amounts held pending use to pay current debt service, present law also limits the amount of the proceeds of private activity bonds (other than qualified 501(c)(3) bonds) that may be invested at materially higher yields at any time during a bond year to 150 percent of the debt service for that bond year. This restriction affects primarily investments in reasonably required reserve or replacement funds. Present law further restricts the amount of proceeds from the sale of bonds that may be invested in these reserve funds to ten percent of such proceeds. The second set of arbitrage restrictions requires generally that all arbitrage profits earned on investments unrelated to the governmental purpose of the borrowing be rebated to the Federal Government. Arbitrage profits include all earnings (in excess of bond yield) derived from the investment of bond proceeds (and subsequent earnings on any such earnings).

Description of Proposal

The proposal would repeal the 150-percent of debt service yield restriction.

Effective Date

The proposal would apply to bonds issued after the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

4. Repeal of expired provisions relating to student loan bonds

Present Law

Present law includes two special exceptions to the arbitrage rebate and pooled financing temporary period rules for certain qualified student loan bonds. These exceptions applied only to bonds issued before January 1, 1989.

Description of Proposal

These special exceptions would be repealed as "deadwood."

Effective Date

The proposal would apply to bonds issued after the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

E. Insurance Provisions

1. Treatment of certain insurance contracts on retired lives

Present Law

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The reserve of a life insurance company for any contract is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. In no event, however, may the amount of the reserve for tax purposes for any contract at any time exceed the amount of the reserve for annual statement purposes.

Special rules are provided in the case of a variable contract. Under these rules, the reserve for a variable contract is adjusted by (1) subtracting any amount that has been added to the reserve by reason of appreciation in the value of assets underlying such contract, and (2) adding any amount that has been subtracted from the reserve by reason of depreciation in the value of assets underlying such contract. In addition, the basis of each asset underlying a variable contract is adjusted for appreciation or depreciation to the extent the reserve is adjusted.

A variable contract generally is defined as any annuity or life insurance contract (1) that provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset accounts of the company, and (2) under which, in the case of an annuity contract, the amounts paid in, or the amounts paid out, reflect the investment return and the market value of the segregated asset account, or, in the case of a life insurance contract, the amount of the death benefit (or the period of coverage) is adjusted on the basis of the investment return and the market value of the segregated asset account. A pension plan contract that is not a life, accident, or health, property, casualty, or liability insurance contract is treated as an annuity contract for purposes of this definition.

Description of Proposal

The proposal would provide that a variable contract is to include a contract that provides for the funding of group term life or group accident and health insurance on retired lives if: (1) the contract provides for the allocation of all or part of the amounts received under the contract to an account that is segregated from the general asset account of the company; and (2) the amounts paid in, or the amounts paid out, under the contract reflect the investment return and the market value of the segregated asset account underlying the contract.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

2. Treatment of modified guaranteed contracts

Present Law

Life insurance companies are allowed a deduction for any net increase in reserves and are required to include in income any net decrease in reserves. The reserve of a life insurance company for any contract is the greater of the net surrender value of the contract or the reserve determined under Federally prescribed rules. The net surrender value of a contract is the cash surrender value reduced by any surrender penalty, except that any market value adjustment required on surrender is not taken into account. In no event, however, may the amount of the reserve for tax purposes for any contract at any time exceed the amount of the reserve for annual statement purposes.

In general, assets held for investment are treated as capital assets. Any gain or loss from the sale or exchange of a capital asset is treated as a capital gain or loss and is taken into account for the taxable year in which the asset is sold or exchanged.

Description of Proposal

The proposal generally would apply a mark-to-market regime to assets held as part of a segregated account under a modified guaranteed contract issued by a life insurance company. Gain or loss with respect to such assets held as of the close of any taxable year would be taken into account for that year (even though the assets have not been sold or exchanged),[1] and would be treated as ordinary. If gain or loss is taken into account by reason of the mark-to-market requirement, then the amount of gain or loss subsequently realized as a result of sale, exchange, or other disposition of the asset, or as a result of the application of the mark-to-market requirement would be appropriately adjusted to reflect such gain or loss. In addition, the reserve for a modified guaranteed contract would be determined by taking into account the market value adjustment required on surrender of the contract.

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[1] The wash sale rules of section 1091 of the Code are not to apply to any loss that is required to be taken into account solely by reason of the mark-to-market requirement.

A modified guaranteed contract would defined as any life insurance contract, annuity contract or pension plan contract[2] that is not a variable contract (within the meaning of Code section 817), and that satisfies the following requirements. All or a part of the amounts received under the contract must be allocated to an account which, pursuant to State law or regulation, is segregated from the general asset accounts of the company and is valued from time to time by reference to market values. The reserves for the contract must be valued at market for annual statement purposes. Further, a modified guaranteed contract includes only a contract that provides either for a net surrender value or for a policyholder's fund. If only a portion of the contract is not described in section 817, that portion is treated as a separate contract for purposes of the provision.

Effective Date

The proposal would apply to taxable years beginning after December 31, 1995. The section 481(a) adjustments required by reason of the changes in method of accounting to which the provision would give rise would be combined and taken into account as a single net adjustment for the taxpayer's first taxable year beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

3. Minimum tax treatment of certain property and casualty insurance companies

Present Law

Present law provides that certain property and casualty insurance companies may elect to be taxed only on taxable investment income for regular tax purposes (sec. 831(b)). Eligible property and casualty insurance companies are those whose net written premiums (or if greater, direct written premiums) for the taxable year exceed $350,000 but do not exceed $1,200,000.

Under present law, all corporations including insurance companies are subject to an alternative minimum tax. Alternative minimum taxable income is increased by 75 percent of the excess of adjusted current earnings over alternative minimum taxable income (determined without regard to this adjustment and without regard to net operating losses).

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[2] The provision applies only to a pension plan contract that is not a life, accident or health, property, casualty, or liability contract.

Description of Proposal

The proposal would provide that a property and casualty insurance company that elects for regular tax purposes to be taxed only on taxable investment income determines its adjusted current earnings under the alternative minimum tax without regard to any amount not taken into account in determining its gross investment income under section 834(b). Thus, adjusted current earnings of an electing company is determined without regard to underwriting income (or underwriting expense, as provided in sec. 56(g)(4)(B)(i)(II).

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

Legislative Background

A similar proposal was included in H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

F. Other Provisions

1. Closing of partnership taxable year with respect to deceased partner

Present Law

The partnership taxable year closes with respect to a partner whose entire interest is sold, exchanged, or liquidated. Such year, however, generally does not close upon the death of a partner. Thus, a decedent's entire share of items of income, gain, loss, deduction and credit for the partnership year in which death occurs is taxed to the estate or successor in interest rather than to the decedent on his or her final income tax return. See Estate of Hesse v. Commissioner, 74 T.C. 1307, 1311 (1980).

Description of Proposal

The proposal would provide that the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation or otherwise. The proposal would not change present law with respect to the effect upon the partnership taxable year of a transfer of a partnership interest by a debtor to the debtor's estate (under Chapters 7 or 11 of Title 11, relating to bankruptcy).

Effective Date

The proposal would apply to partnership taxable years beginning after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.), and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

2. Modifications to the FICA tip credit

Present Law

Under present law, all employee tip income is treated as employer-provided wages for purposes of the Federal Insurance Contributions Act ("FICA") (sec. 3121(q)). Employees are required to report to the employer the amount of tips received (sec. 6053(a)).

The Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") provided a business tax credit with respect to certain employer FICA taxes paid with respect to tips that are treated as paid by the employer. In determining the credit, tips are taken into account only if they are

received from customers in connection with the provision of food or beverages for consumption on the premises of an establishment with respect to which the tipping of employees serving food or beverages by customers is customary. In addition, the credit only applies with respect to tips that exceed the amount by which the wages paid by the employer (excluding tips) are less than the amount of the minimum wage.

OBRA 1993 provides that the FICA tip credit is effective for taxes paid after December 31, 1993.

Temporary Treasury regulations provide that the tax credit is available only with respect to tips reported by the employee. The temporary regulations also provide that the credit is effective for FICA taxes paid by an employer after December 31, 1993, with respect to tips received for services performed after December 31, 1993.

Description of Proposal

The proposal would clarify the credit with respect to employer FICA taxes paid on tips by providing that the credit is (1) available whether or not the employee reported the tips on which the employer FICA taxes were paid pursuant to section 6053(a), and (2) effective with respect to taxes paid after December 31, 1993, regardless of when the services with respect to which the tips are received were performed.

Effective Date

The proposal would be effective as if included in OBRA 1993.

3. Conform due date for first quarter estimated tax by private foundations

Present Law

Under section 4940, tax-exempt private foundations generally are required to pay an excise tax equal to two percent of their net investment income for the taxable year. Under section 6655(g)(3), private foundations are required to pay estimated tax with respect to their excise tax liability under section 4940.[1] Section 6655(c) provides that this estimated tax is payable in quarterly installments and that, for calendar-year foundations, the first quarterly installment is due on April 15th. Under section 6655(i), foundations with taxable years other than the calendar year must make their quarterly estimated tax payments no later than the dates in their fiscal years that correspond to the dates applicable to calendar-year foundations.

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[1] Generally, the amount of the first quarter payment must be at least 25 percent of the lesser of (1) the prior year's tax liability, as shown on the foundation's Form 990-PF, or (2) 95 percent of the foundation's current-year tax liability.

Description of Proposal

The proposal would amend section 6655(g)(3) to provide that a calendar-year foundation's first quarter estimated tax payment is due on May 15th (which is the same day that its annual return, Form 990-PF, for the preceding year is due). As a result of the operation of present-law section 6655(i), fiscal-year foundations would be required to make their first quarterly estimated tax payment no later than the 15th day of the fifth month of their taxable year.

Effective Date

The proposal would apply to taxable years beginning after 1995.

Legislative Background

The proposal was introduced as section 3 of H.R. 733 by Mr. Jacobs (for himself and Mr. Camp) on January 30, 1995.

VI. ESTATE, GIFT, AND TRUST TAX SIMPLIFICATION

A. Estate and Trust Income Tax Provisions

1. Certain revocable trusts treated as part of estate

Present Law

Both estates and revocable intervivos trusts can function to wind up the affairs of a decedent and distribute assets to heirs. In the case of revocable intervivos trusts, the grantor transfers property into a trust which is revocable during his or her lifetime. Upon the grantor's death, the power to revoke ceases and the trustee then performs the winding up functions typically performed by the executor of an estate. While both estates and revocable trusts perform essentially the same function after the testator or grantor's death, there are a number of ways in which an estate and a revocable trust operate in different ways. First, there can be only one estate per decedent while there can be more than one revocable trust. Second, estates are in existence only for a reasonable period of administration; revocable trusts can perform the same winding up functions as an estate, but may continue in existence thereafter as testamentary trusts.

Numerous differences presently exist between the income tax treatment of estates and revocable trusts, including: (1) estates are allowed a charitable deduction for amounts permanently set aside for charitable purposes while post death revocable trusts are allowed a charitable deduction only for amounts paid to charities; (2) the active participation requirement the passive loss rules under section 469 is waived in the case of estates (but not revocable trusts) for 2 years after the owner's death; (3) an estate is a qualified shareholder of an S corporation, while a revocable trust may not be; and (4) estates can qualify for section 194 amortization of reforestation expenditures, while trusts do not.

Description of Proposal

The proposal would provide an irrevocable election to treat a qualified revocable trust as part of the decedent's estate for Federal income tax purposes. This elective treatment would be effective from the date of the decedent's death until two years after his or her death (if no estate tax return is required) or six months after the final determination of estate tax liability (if an estate tax return is required). The election must be made by both the executor of the decedent's estate and the trustee of the revocable trust no later than the time required for filing the income tax return of the estate for its first taxable year, taking into account any extensions. A conforming change would be made to section 2652(b) for generation-skipping transfer tax purposes.

For this purpose, a qualified revocable trust would be any trust all of which was treated under section 676 as owned by the decedent with respect to whom the election is being made.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

2. Distributions during first 65 days of taxable year of estate

Present Law

In general, trusts and estates are treated as conduits for Federal income tax purposes; income received by a trust or estate that is distributed to a beneficiary in the trust or estate's taxable year "ending with or within" the taxable year of the beneficiary is taxable to the beneficiary in that year; income that is retained by the trust or estate is initially taxable to the trust or estate. In the case of distributions of previously accumulated income by trusts (but not estates), there may be additional tax under the so-called "throwback" rules if the beneficiary to whom the distributions were made has marginal rates higher than those of the trust. Under the"65-day rule", a trust may elect to treat distributions paid within 65 days after the close of its taxable year as paid on the last day of its taxable year. The 65-day rule is not applicable to estates.

Description of Proposal

The proposal would extend application of the 65-day rule to distributions by estates. Thus, an executor could elect to treat distributions paid within 65 days after the close of the estate's taxable year as having been paid on the last day of such taxable year.

Effective Date

The proposal would apply to taxable years beginning after the date of enactment.

3. Separate share rules available to estates

Present Law

Trusts with more than one beneficiary must use the "separate share" rule in order to provide different tax treatment of distributions to different beneficiaries to reflect the income earned by different shares of the trust's corpus.[1] Treasury regulations provide that "[t]he application of the separate share rule . . . will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. . . . Separate share treatment will not be applied to a trust or portion of a trust subject to a power to distribute, apportion, or accumulate income or distribute corpus to or for the use of one or more beneficiaries within a group or class of beneficiaries, unless the payment of income, accumulated

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[1] Application of the separate share rule is not elective; it is mandatory if there are separate shares in the trust.

income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made under the governing instrument so that substantially separate and independent shares exist." (Treas. Reg. sec. 1.663(c)-3). The separate share rule presently does not apply to estates.

Description of Proposal

The proposal would extend the application of the separate share rule to estates.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

4. Executor of estate and beneficiaries treated as related persons for disallowance of losses

Present Law

Section 267 disallows a deduction for any loss on the sale of an asset to a person related to the taxpayer. For the purposes of section 267, the following parties are related persons: (1) a trust and the trust's grantor, (2) two trusts with the same grantor, (3) a trust and a beneficiary of the trust, (4) a trust and a beneficiary of another trust, if both trusts have the same grantor, and (5) a trust and a corporation the stock of which is more than 50 percent owned by the trust or the trust's grantor.

Section 1239 disallows capital gain treatment on the sale of depreciable property to a related person. For purposes of section 1239, a trust and any beneficiary of the trust are treated as related persons, unless the beneficiary's interest is a remote contingent interest.

Neither section 267 or section 1239 presently treat an estate and a beneficiary of the estate as related persons.

Description of Proposal

Under the proposal, an estate and a beneficiary of that estate would be treated as related persons for purposes of sections 267 and 1239, except in the case of a sale or exchange in satisfaction of a pecuniary bequest.

Effective Date

The proposal would apply to taxable years beginning after the date of enactment.

5. Limitation on taxable year of estates

Present Law

The taxability of distributions from a trust or estate is based on the amount of income received by the trust or estate in the trust or estate's taxable year "ending with or within" the taxable year of the beneficiary (typically a calendar year). Trusts are required to use a calendar year and, consequently, income of a trust that is distributed to a calendar-year beneficiary in the year earned is taxed to the beneficiary in the year earned. Estates, on the other hand, are allowed to use any fiscal year. Consequently, in the case of estates, the taxation of distributions to a calendar-year beneficiary in up to the last 11 months of the calendar year can be deferred until the next taxable year depending upon the fiscal year selected.

Description of Proposal

The proposal would limit the taxable year of an estate to a year ending on October 31, November 30, or December 31. Thus, the maximum deferral allowed to a calendar-year beneficiary would be with respect to distributions made in the last two months of the calendar year.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

6. Repeal of throwback rules applicable to domestic trusts

Present Law

Under present law, income which is accumulated in a trust is taxable to the trust instead of its beneficiaries. Trusts are subject to their own set of tax rates which historically has permitted trust income to be taxed at lower rates than the rates applicable to its beneficiaries. This benefit often was compounded through the creation of multiple trusts. The Internal Revenue Code has a series of rules to limit the benefit that would otherwise occur from using the lower rates applicable to one or more trusts. Under the so-called "throwback" rules, the distribution of previously accumulated trust income to a beneficiary will be subject to tax (in addition to any tax paid by the trust on that income) where the beneficiary's average top marginal rate in the previous 5 years is higher than those of the trust.

Under section 643(f), two or more trusts are treated as one trust if (1) the trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose for the existence of the trusts is to avoid Federal income tax. For trusts that were irrevocable as of March 1, 1984, section 643(f) applies only to contributions to corpus after that date.

Under section 644, if property is sold within two years of its contribution to a trust, the gain that would have been recognized had the contributor sold the property is taxed at the contributor's marginal tax rates. In effect, section 644 treats such gains as if the contributor had realized the gain and then transferred the net after-tax proceeds from the sale to the trust as corpus.

In the Tax Reform Act of 1986, Congress provided a new rate schedule for estates and trusts under which the maximum tax benefit of the graduated rate structure applicable to estates or trusts was slightly more than $600 per year for a trust or estate. Because of indexing of the rate brackets, that benefit has increased to $845 per year per trust or estate.

Description of Proposal

The proposal would exempt from the throwback rules amounts distributed by a domestic trust after December 31, 1995. The proposal also would provide that precontribution gain on property sold by a domestic trust no longer would be subject to section 644 (i.e., taxed at the contributor's marginal tax rates).

Effective Date

The proposal with respect to the throwback rules would be effective for distributions made in taxable years beginning after December 31, 1995. The modification to section 644 would apply to sales or exchanges after December 31, 1995.

Legislative Background

A similar proposal was passed by Congress in 1992 as part of the simplification provisions in H.R. 11. H.R. 11 was vetoed by President Bush.

7. Simplified taxation of earnings of pre-need funeral trusts

Present Law

A pre-need funeral trust is an arrangement where an individual purchases funeral or burial services or merchandise from a funeral home or cemetery in advance of the individual's death. The individual enters into a contract with the provider of such services or merchandise whereby the individual selects the services or merchandise to be provided upon his or her death, and agrees to pay for them in advance of his or her death. Such amounts (or a portion thereof) are held in trust during the individual's lifetime and are paid to the seller upon the individual's death.

Under present law, pre-need funeral trusts generally are treated as grantor trusts, and the annual income earned by such trusts is taxed to the purchaser/grantor of the trust. Rev. Rul. 87-127. Any amount received from the trust by the seller (as payment for services or merchandise) is

includible in the gross income of the seller.

Description of Proposal

Pre-need funeral trusts essentially would be treated as non-grantor trusts, if the trustee so elects. If the election is made, a single annual trust return would be filed by the trustee, separately listing the amount of income earned with respect to each purchaser. Each purchaser's share of the trust would be treated as a separate subtrust. The amount of tax paid with respect to each subtrust would be determined in accordance with the income tax rate schedule generally applicable to estates and trusts (Code sec. 1(e)), but no deduction would be allowed under section 642(b). The tax on the annual earnings of the trust would be payable by the trustee. As under present law, any amount received from the trust by the seller as payment for services or merchandise would be includible in the gross income of the seller.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1995.

B. Estate and Gift Tax Provisions

1. Clarification of waiver of certain rights of recovery

Present Law

For estate and gift tax purposes, a marital deduction is allowed for qualified terminable interest property (QTIP). Such property generally is included in the surviving spouse's gross estate upon his or her death. The surviving spouse's estate is entitled to recover the portion of the estate tax attributable to inclusion of QTIP from the person receiving the property, unless the spouse directs otherwise by will (sec. 2207A). For this purpose, a will provision specifying that all taxes shall be paid by the estate is sufficient to waive the right of recovery.

A decedent's gross estate includes the value of previously transferred property in which the decedent retains enjoyment or the right to income (sec. 2036). The estate is entitled to recover from the person receiving the property a portion of the estate tax attributable to the inclusion (sec. 2207B). This right may be waived only by a provision in the will (or revocable trust) specifically referring to section 2207B.

Description of Proposal

The proposal would provide that the right of recovery with respect to QTIP is waived only to the extent that language in the decedent's will or revocable trust specifically so indicates. Thus, a general provision specifying that all taxes be paid by the estate would no longer be sufficient to waive the right of recovery. The proposal also would provide that the right of contribution for property over which the decedent retained enjoyment or the right to income is waived by a specific indication in the decedent's will or revocable trust, but specific reference to section 2207B would no longer be required.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

Legislative Background

A similar proposal was passed by Congress in 1992 as part of the simplification provisions in H.R. 11. H.R. 11 was vetoed by President Bush.

2. Adjustments for gifts within three years of decedent's death

Present Law

The first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax.

The value of the gross estate includes the value of any previously transferred property if the decedent retained the power to revoke the transfer (sec. 2038). The gross estate also includes the value of any property with respect to which such power is relinquished during the three years before death (sec. 2035). This rule has been interpreted to include in the gross estate certain transfers made from a revocable trust within three years of death.[2] Such inclusion subjects gifts that would otherwise qualify under the annual $10,000 exclusion to estate tax. It is understood that repeal of such inclusion eliminates a principal tax disadvantage of funded revocable trusts, which are generally used for nontax purposes.

Description of Proposal

The proposal would provide that a transfer from a revocable trust (i.e., a trust described under section 676) would be treated as if made directly by the grantor. Thus, an annual exclusion gift from such trust would not be included in the gross estate.

The proposal also would revise section 2035 to improve its clarity.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

Legislative Background

A similar proposal was passed by Congress in 1992 as part of the simplification provisions in H.R. 11. H.R. 11 was vetoed by President Bush.

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[2] See, e.g., Jalkut Estate v. Commissioner, 96 T.C. 675 (1991) (transfers from revocable trust to permissible beneficiaries of the trust includible in the grantor's gross estate); LTR 9117003 (same).

3. Clarification of qualified terminable interest rules

Present Law

A marital deduction is allowed for qualified terminal interest property ("QTIP"). Property is QTIP only if the surviving spouse has a qualifying income interest for life (e.g., the spouse is entitled to all of the income from the property payable at least annually). QTIP generally is includible in the surviving spouse's gross estate.

The United States Tax Court has held that, in order to satisfy the QTIP requirements, the income accumulating between the last distribution date and the date of the surviving spouse's death (the "accumulated income") must be paid to the spouse's estate or be subject to a power of appointment held by the spouse. See Estate of Howard v. Commissioner, 91 T.C. 329, 338 (1988), rev'd, 910 F.2d 633 (9th Cir. 1990). In contrast, proposed Treasury regulations presently provide that an income interest may constitute a qualifying income interest for life even if the accumulated income is not required to be distributed to the surviving spouse or the surviving spouse's estate. See Prop. Reg. secs. 20.2056(b)-7(c)(1), 25.2523(f)-1(b).

Description of Proposal

Under the proposal, an income interest would not fail to be a qualified income interest for life solely because the accumulated income is not required to be distributed to the surviving spouse. Such income would be includible in the surviving spouse's gross estate.

Effective Date

The proposal would apply to decedents dying, and gifts made, after the date of enactment. However, the proposal would not include in the surviving spouse's gross estate property transferred before the date of enactment for which no marital deduction was claimed.

Legislative Background

A similar proposal was passed by Congress in 1992 as part of the simplification provisions in H.R. 11. H.R. 11 was vetoed by President Bush.

4. Transitional rule under section 2056A

Present Law

A "marital deduction" generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") denied the marital deduction for property passing to an alien spouse outside a qualified domestic trust ("QDT"). An estate tax generally is imposed on corpus distributions from a QDT.

TAMRA defined a QDT as a trust that, among other things, required all trustees be U.S. citizens or domestic corporations. This provision was modified in the Omnibus Budget Reconciliation Acts of 1989 and 1990 to require that at least one trustee be a U.S. citizen or domestic corporation and that no corpus distribution be made unless such trustee has the right to withhold any estate tax imposed on the distribution (the "withholding requirement").

Description of Proposal

A trust created before the enactment of the Omnibus Budget Reconciliation Act of 1990 would be treated as satisfying the withholding requirement if its governing instrument requires that all trustees be U.S. citizens or domestic corporations.

Effective Date

The proposal would apply as if included in the Omnibus Budget Reconciliation Act of 1990.

Legislative Background

A similar proposal was passed by Congress in 1992 as part of the simplification provisions in H.R. 11. H.R. 11 was vetoed by President Bush.

5. Opportunity to correct certain failures under section 2032A

Present Law

For estate tax purposes, an executor may elect to value certain real property used in farming or other closely held business operations at its current use value rather than its highest and best use (sec. 2032A). A written agreement signed by each person with an interest in the property must be filed with the election.

Treasury regulations require that a notice of election and certain information be filed with the Federal estate tax return (Treas. Reg. sec. 20.2032A-8). The administrative policy of the Treasury Department is to disallow current use valuation elections unless the required information is supplied.

Under procedures prescribed by the Treasury Department, an executor who makes the election and substantially complies with the regulations but fails to provide all required information or the signatures of all persons with an interest in the property may supply the missing information within a reasonable period of time (not exceeding 90 days) after notification by the Treasury Department.

Description of Proposal

The proposal would extend the procedures allowing subsequent submission of information to any executor who makes the election and submits the recapture agreement, without regard to compliance with the regulations. Thus, the proposal would allow the current use valuation election if the executor supplies the required information within a reasonable period of time (not exceeding 90 days) after notification by the IRS. During that time period, the proposal also would allow the addition of signatures to a previously filed agreement.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

Legislative Background

A similar proposal was passed by Congress in 1992 as part of the simplification provisions in H.R. 11. H.R. 11 was vetoed by President Bush.

6. Unified credit of decedent increased by unified credit of spouse used on split gift included in decedent's gross estate

Present Law

A gift tax is imposed on transfers by gift during life and an estate tax is imposed on transfers at death. The gift and estate taxes are a unified transfer tax system in that one progressive tax is imposed on the cumulative transfers during the lifetime and at death. The amount of gift tax payable for any taxable period generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period. Also, the first $10,000 of gifts of present interests to each donee during any one calendar year are excluded from Federal gift tax.

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post-1976 taxable transfers made by the taxpayer and then subtracting any transfer taxes payable for prior taxable periods. This amount is reduced by any remaining available unified credit (and other applicable credits) to determine the estate tax liability. The estate tax is imposed on all of the assets held by the decedent at his death, including the value of property previously transferred by the decedent in which the decedent had certain retained powers or interests (e.g., sections 2036 (relating to transfers with retained life estate), 2037 (relating to transfers taking effect at death), 2038 (relating to revocable trusts), or 2042 (relating to proceeds of life insurance)). Under section 2035, the estate tax would also apply with respect to property in which such a retained power or interest is transferred within three years of death.

Under section 2513, one spouse can elect to treat a gift made by the other spouse to a third person as made one-half by each spouse (i.e., "gift-splitting"). This effectively permits the transferor taxpayer to benefit from any annual exclusion, unified credit and lower gift tax brackets allowable to the non-transferor spouse. These tax benefits of gift-splitting, however, will be lost in circumstances where the split-gift property is subsequently included in the transferor spouse's estate under section 2035 (i.e., the transferor spouse dies within three years of the date of the transfer and the transferor spouse had retained sufficient interests such that the entire transferred interest is includible in the transferor's estate).

Description of Proposal

With respect to any split-gift property that is subsequently included in the estate of the transferor spouse under section 2035, the proposal would increase the unified credit allowable to his or her estate by the amount of the unified credit previously allowed to the nontransferor spouse with respect to the split gift.

Effective Date

The proposal would apply to gifts made after the date of enactment.

7. Reformation of defective bequests to spouse of decedent

Present Law

A "marital deduction" generally is allowed for estate and gift tax purposes for the value of property passing to a spouse. However, "terminable interest" property (i.e., an interest in property that will terminate or fail) transferred to a spouse generally will only qualify for the marital deduction under certain special rules designed to ensure that there will be an estate or gift tax to the transferee spouse on unspent transferred proceeds. Thus, the effect of a marital deduction with the terminable interest rule is to provide only a method of deferral of the estate or gift tax, not exemption. One of the special terminable interest rules (Code sec. 2056(b)(5)) provides that the marital deduction is allowed where the decedent transfers property to a trust that is required to pay income to the surviving spouse and the surviving spouse has a general power of appointment at that spouse's death (under this so-called "power of appointment trust", the power of appointment both provides the surviving spouse with power to control the ultimate disposition of the trust assets and assures that the trust assets will be subject to estate or gift tax). Another special terminable interest rule called the "qualified terminable interest property" rule ("QTIP") permits a marital deduction for transfers to a trust that is required to distribute income to the surviving spouse if an election is made to subject the transferee spouse to transfer tax on the trust property. To qualify for the marital deduction, a power of appointment trust or QTIP trust must meet certain specific requirements. If there is a technical defect in meeting those requirements, the marital deduction may be lost.

Description of Proposal

The proposal would allow the marital deduction with respect to a defective trust if there is a "qualified reformation" of the trust that corrects the defect. In order to qualify, the reformation must change the governing instrument in a manner that cures the defects to qualification of the trust for the marital deduction. In addition, where a reformation proceeding is commenced after the due date for the estate tax return (including extensions), the reformation would qualify only if, prior to reformation, the governing instrument provides (1) that the surviving spouse is entitled to all of the income from the property for life, and (2) no person other than the surviving spouse is entitled to any distributions during the surviving spouse's life.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

8. Gifts may not be revalued for estate tax purposes after expiration of statute of limitations

Present Law

The Federal estate and gift taxes are unified so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The tax on gifts made in a particular year is computed by determining the tax on the sum of the taxable gifts made that year and all prior years and then subtracting the tax on the prior years taxable gifts and the unified credit. Similarly, the estate tax is computed by determining the tax on the sum of the taxable estate and prior taxable gifts and then subtracting the tax on taxable gifts and the unified credit. Under a special rule applicable to the computation of the gift tax (sec. 2504(c)), the value of gifts made in prior years is the value that was used to determine the prior year's gift tax. There is no comparable rule in the case of the computation of the estate tax.

Generally, any estate or gift tax must be assessed within 3 years after the filing of the return. No proceeding in a court for the collection of an estate or gift tax can be begun without an assessment within the 3-year period. If no return is filed, the tax may be assessed, or a suit commenced to collect the tax without assessment, at any time. If an estate or gift tax return is filed, and the amount of unreported items exceeds 25 percent of the amount of the reported items, the tax may be assessed or a suit commenced to collect the tax without assessment, within 6 years after the return was filed (sec. 6501).

Commencement of the statute of limitations generally does not require that a particular gift be disclosed. A special rule, however, applies to certain gifts that are valued under the special valuation rules of Chapter 14. The gift tax statute of limitations runs for such a gift only if it is disclosed on a gift tax return in a manner adequate to apprise the Secretary of the Treasury of the nature of the item.

Most courts have permitted the Commissioner to redetermine the value of a gift for which the statute of limitations period for the gift tax has expired in order to determine the appropriate tax rate bracket and unified credit for the estate tax. See, e.g., Evanson v. United States, 74 AFTR 2d 94-5128 (9th Cir. 1994); Stalcup v. United States, 946 F. 2d 1125 (5th Cir. 1991); Estate of Levin, 1991 T.C. Memo 1991-208, aff'd 986 F. 2d 91 (4th Cir. 1993); Estate of Smith v. Commissioner, 94 T.C. 872 (1990). But see Boatman's First National Bank v. United States, 705 F. Supp. 1407 (W.D. Mo. 1988) (Commissioner not permitted to revalue gifts).

Description of Proposal

The proposal would provide that a gift for which the limitations period has passed cannot be revalued for purposes of determining the applicable estate tax bracket and available unified credit. For gifts made after the date of enactment, the proposal also would extend the special rule governing gifts valued under Chapter 14 to all gifts. Thus, the statute of limitations would not run on an inadequately disclosed transfer after the date of enactment, regardless of whether a gift tax return was filed for other transfers in that same year.

Effective Date

The proposal generally would apply to gifts made after the date of enactment. The extension of the special rule under chapter 14 to all gifts would apply to gifts made in calendar years after the date of enactment.

9. Clarifications relating to disclaimers

Present Law

Historically, there must be acceptance of a gift in order for the gift to be completed under State law and there is no taxable gift for Federal gift tax purposes unless there is a completed gift. Most States have rules that provide that, where there is a disclaimer of a gift, the property passes to the person who would be entitled to the property had the disclaiming party died before the purported transfer.

In the Tax Reform Act of 1976, Congress provided a uniform disclaimer rule (section 2518) that specified how and when a disclaimer must be made in order to be effective for Federal transfer tax purposes. Under section 2518, a disclaimer is effective for Federal transfer tax purposes if it is an irrevocable and unqualified refusal to accept an interest in property and certain other requirements are satisfied. One of these other requirements is that the disclaimer generally must be made in writing not later than nine months after the transfer creating the interest occurs. Section 2518 is not presently effective for Federal tax purposes other than transfer taxes.

In 1981, Congress added a rule to section 2518 that allowed certain transfers of property to be treated as a qualified disclaimer. In order to qualify, these transfer-type disclaimers must be a

written transfer of the disclaimant's "entire interest in the property" to persons who would have received the property had there been a valid disclaimer under State law (sec. 2518(c)(3)). Like other disclaimers, the transfer-type disclaimer generally must be made within nine months of the transfer creating the interest.

Description of Proposal

The proposal would allow a transfer-type disclaimer of an "undivided portion" of the disclaimant transferor's interest in property to qualify under section 2518. Also, the proposal would allow a spouse to make a qualified transfer-type disclaimer where the disclaimed property is transferred to a trust in which the disclaimant spouse has an interest (e.g., a credit shelter trust). Finally, the proposal would provide that a qualified disclaimer for transfer tax purposes under section 2518 would also be effective for Federal income tax purposes (e.g., disclaimers of interests in annuities and income in respect of a decedent).

Effective Date

The proposal would apply to disclaimers made after the date of enactment.

10. Clarify relationship between community property rights and retirement benefits

Present Law

Community property

Under state community property laws, each spouse owns an undivided one-half interest in each community property asset. In community property jurisdictions, a nonparticipant spouse may be treated as having a vested community property interest in either his or her spouse's qualified plan, individual retirement arrangement ("IRA"), or simplified employee pension ("SEP") plan.

Transfer tax treatment of qualified plans

In the Retirement Equity Act of 1984 ("REA"), qualified retirement plans were required to provide automatic survivor benefits (1) in the case of a participant who retires under the plan, in the form of a qualified joint and survivor annuity, and (2) in the case of a vested participant who dies before the annuity starting date and who has a surviving spouse, in the form of a preretirement survivor annuity. A participant is generally permitted to waive such annuities, provided he or she obtains the written consent of his or her spouse.

The Tax Reform Act of 1986 repealed the estate tax exclusion, formerly contained in sections 2039(c) and 2039(d), for certain interests in qualified plans owned by a nonparticipant spouse attributable to community property laws and made certain other changes to conform the transfer tax treatment of qualified and nonqualified plans.

As a result of these changes made by REA and the Tax Reform Act of 1986, the transfer tax treatment of married couples residing in a community property state is unclear where either spouse is covered by a qualified plan.

Description of Proposal

The proposal would clarify that the marital deduction is available with respect to a nonparticipant spouse's interest in an IRA, SEP, or qualified pension plan (collectively hereinafter referred to as a "plan") attributable to community property laws where he or she predeceases the participant spouse. Under the proposal, the nonparticipant spouse's interest in a plan that passes to the surviving participant spouse is deemed to qualify for treatment as qualified terminable interest property (QTIP) under section 2056(b)(7).[3]

Effective Date

The proposal would apply to decedents dying, or waivers, transfers and disclaimers made, after the date of enactment.

11. Treatment under qualified domestic trust rules of forms of ownership which are not trusts

Present Law

Trusts are not permitted in some countries (e.g., many civil law countries).[4] As a result, it is not possible to create a QDT in those countries.

Description of Proposal

The proposal would provide the Treasury Department with regulatory authority to treat as trusts legal arrangements that have substantially the same effect as a trust.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

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[3] In general, QTIP is property which passes from the decedent, in which the surviving spouse has a qualifying income interest for life, and which the executor elected to treat as QTIP. A surviving spouse generally has a qualifying income interest for life if he or she is entitled to all the income from the property payable at least annually, and no person has the power to appoint any part of the property to any person other than the surviving spouse.

[4] Note that in some civil law States (e.g., Louisiana) an entity similar to a trust, called a usufruct, exists.

12. Authority to waive requirement of U.S. trustee for qualified domestic trusts

Present Law

In order for a trust to be a QDT, a U.S. trustee must have the power to approve all corpus distributions from the trust. In some countries, trusts cannot have any U.S. trustees. As a result, trusts established in those countries cannot qualify as a QDT.

Description of Proposal

In order to permit the establishment of a QDT in countries that prohibit a trust from having a U.S. trustee, the proposal would provide the Treasury Department with regulatory authority to waive the requirement that a QDT have a U.S. trustee. It is anticipated that such regulations, if any, would provide an alternative mechanism under which the U.S. would retain jurisdiction to impose gift and estate tax on transfers by the surviving spouse of the property transferred by the deceased spouse.

Effective Date

The proposal would apply to decedents dying after the date of enactment.

C. Generation-Skipping Tax Provisions

1. Severing of trusts holding property having an inclusion ratio of greater than zero

Present Law

A generation-skipping transfer tax ("GST" tax) generally is imposed on transfers, either directly or through a trust or similar arrangement, to a skip person (i.e., a beneficiary in more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations and taxable distributions. An exemption of $1 million is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property .

If the value of the transferred property exceeds the amount of the GST exemption allocated to that property, the GST tax generally is determined by multiplying a flat rate equal to the highest estate tax rate (i.e., currently 55%) by the "inclusion percentage" and the value of the taxable property at the time of the taxable event. The "inclusion percentage" is the number one minus the "exclusion percentage". The exclusion percentage generally is calculated by dividing the amount of the GST exemption allocated to the property by the value of the property.

Description of Proposal

If a trust with an inclusion ratio of greater than zero is severed into two separate trusts, the proposal would allow the trustee to elect to treat one of the separate trusts as having an inclusion ratio of zero and the other separate trust as having an inclusion ratio of one. To qualify for this treatment, the separate trust with the inclusion ratio of one must receive an interest in each property held by the single trust (prior to severance) equal to the single trust's inclusion ratio, except to the extent otherwise provided by regulation. The remaining interests in each property would be transferred to the separate trust with the inclusion ratio of zero. The election must be made at a time and in a manner prescribed by the Treasury Department.

Effective Date

The proposal would be effective for severances of trusts occurring after the date of enactment.

2. Clarification of who is transferor where subsequent gift by reason of power of appointment

Present Law

The exercise or release of a general power of appointment (e.g., a power of withdrawal) generally is treated as a transfer of property by the person who possesses such power (sec. 2514(b)). Under section 2514(e), the lapse of a general power of appointment also is treated as a taxable

transfer except to the extent that the power does not exceed the greater of $5,000 or 5 percent of the fair market value of the property with respect to which the power could have been exercised. Example 5 of Prop. Treas. Reg. sec. 26.2652-1(a)(5) involves a trust created by a parent that provided an income interest to his child for life, remainder to his grandchild with the child having a power to withdraw $10,000 within 60 days of the creation of the trust. The example states that the parent is the transferor with respect to the entire trust and the child is the transferor as to the excess of $10,000 over the greater of $5,000 or 5 percent of the trust.

Description of Proposal

The proposal would provide that an individual cannot be treated as a "transferor" with respect to any portion of property with respect to which another person is treated as the "transferor" by reason of the exercise, release or lapse of a general power of appointment with respect to such property. Thus, in Example 5 of Prop. Treas. Reg. sec. 26.2652-1(a)(5), the parent would not be treated as the transferor with respect to any portion of the trust which the child is deemed to have transferred.

Effective Date

The proposal would apply to the exercise, release or lapse of a general power of appointment occurring after the date of enactment.

3. Taxable termination not to include direct skips

Present Law

A generation-skipping transfer tax ("GST" tax) generally is imposed on transfers, either directly or through a trust or similar arrangement, to a skip person (i.e., a beneficiary in more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations and taxable distributions. For this purpose, a direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (sec. 2612(c)(1)). A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person (sec. 2612(a)). A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or a direct skip)(sec. 2612(b)). Present law is unclear whether a transaction should be taxed as a direct skip or a taxable termination where the transaction meets both definitions (e.g., a distribution from a marital deduction trust to the creator's grandchildren upon the death of the creator's spouse).

Direct skips are subject to less GST tax than taxable terminations and distributions since the GST tax on direct skips is paid by the transferor (sec. 2603(a)(3)) and, therefore, the tax base for a direct skip is tax exclusive (like the Federal gift tax), while the GST tax on taxable terminations and

distributions is paid by the trust or beneficiary (secs. 2603(a)(1) & (2)) and, therefore, the tax base on taxable terminations and distributions is tax inclusive (like the Federal estate tax).

Description of Proposal

The proposal would provide that, when a transfer is described as both a direct skip and a taxable termination, the transaction will be treated as a direct skip (i.e., treatment as a direct skip takes precedence over treatment as a taxable termination).

Effective Date

The proposal would be effective for generation skipping transfers occurring after the date of enactment.

4. Modification of generation-skipping transfer tax for transfers to individuals with deceased parents

Present Law

Under the "predeceased parent exception", a direct skip transfer to a transferor's grandchild is not subject to the generation skipping transfer ("GST") tax if the child of the transferor who was the grandchild's parent is deceased at the time of the transfer (sec. 2612(c)(2)). This "predeceased parent exception" to the GST tax is not applicable to (1) transfers to collateral heirs, e.g., grandnieces or grandnephews, or (2) taxable terminations or taxable distributions.

Description of Proposal

The proposal would extend the predeceased parent exception to transfers to collateral heirs, provided that the decedent has no living lineal descendants at the time of the transfer. In addition, the proposal would extend the predeceased parent exception (as modified by the preceding sentence) to certain taxable terminations and taxable distributions.

Effective Date

The proposal would be effective for generation skipping transfers occurring after the date of enactment.

VII. EXCISE TAX SIMPLIFICATION

A. Provisions Relating to Distilled Spirits, Wines, and Beer

Present Law

Credit or refund for imported bottled distilled spirits returned to bonded premises

Present law provides that when tax-paid distilled spirits which have been withdrawn from bonded premises of a distilled spirits plant are returned for destruction or redistilling, the excise tax is refunded (sec. 5008(c)). This provision does not apply to imported bottled distilled spirits because they are withdrawn from customs custody and not from bonded premises of a distilled spirits plant.

Authority to cancel or credit bonds without submission of records

Bond generally must be furnished to the Treasury Department when distilled spirits are removed from bonded premises of a distilled spirits plant for exportation without payment of tax. These bonds are canceled or credited when evidence is submitted to the Treasury that the distilled spirits have been exported (sec. 5175(c)).

Required maintenance of records on premises of distilled spirits plant

Distilled spirits plant proprietors are required to maintain records of their production, storage, denaturation, and other processing activities on the premises where the operations covered by the records are carried out (sec. 5207(c)).

Transfers from breweries to distilled spirits plants

Under present law, beer may be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, but only if the brewery is contiguous to the distilled spirits plant (sec. 5222(b)).

Requirement for wholesale dealers in liquors to post sign

Wholesale liquor dealers (i.e., dealers, other than wholesale dealers in beer alone, who sell distilled spirits, wines, or beer to other persons who re-sell such products) are required to post a sign conspicuously on the outside of their place of business indicating that they are wholesale liquor dealers (sec. 5115).

Refund of tax on wine returned to bond

Under present law, when unmerchantable wine is returned to bonded production premises, tax that has been paid is returned or credited to the proprietor of the bonded wine cellar to which the wine is delivered (sec. 5044). In contrast, when beer is returned to a brewery, tax that has been paid is returned or credited, regardless of whether the beer is unmerchantable (sec. 5056(a)).

Use of ameliorating material in certain wines

The Code contains rules governing the extent to which ameliorating material (e.g., sugar) may be added to wines made from high acid fruits and the product still be labelled as a standard, natural wine. In general, ameliorating material may not exceed 35 percent of the volume of juice and ameliorating material combined (sec. 5383(b)(1)). However, wines made exclusively from loganberries, currants, or gooseberries are permitted a volume of ameliorating material of up to 60 percent (sec. 5384(b)(2)(D)).

Domestically produced beer for use by foreign embassies, etc.

Under present law, domestically produced distilled spirits and wine may be removed from bond, without payment of tax, for transfer to any customs bonded warehouse for storage pending removal for the official or family use of representatives of foreign governments or public international organizations (secs. 5066 and 5362(e)). A similar rule also applies to imported distilled spirits, wine, and beer. No such provision exists under present law for domestically produced beer.

Withdrawal of beer for destruction

Present law does not specifically permit beer to be removed from a brewery for destruction without payment of tax.

Records of exportation of beer

Present law provides that a brewer is allowed a refund of tax paid on exported beer upon submission to Treasury Department of certain records indicating that the beer has been exported (sec. 5055).

Transfer to brewery of beer imported in bulk

Imported beer brought into the United States in bulk containers may not be transferred from customs custody to brewery premises without payment of tax. Under certain circumstances, distilled spirits imported into the United States in bulk containers may be transferred from customs custody to bonded premises of a distilled spirits plant where bottling will occur without payment of tax (sec. 5232).

Description of Proposals

Several administrative provisions governing the alcoholic beverage taxes would be amended to conform them to current tax collection procedures, and would conform the tax rules for distilled spirits, wine, and beer in certain cases when current law rules are inconsistent.

Credit or refund for imported bottled distilled spirits returned to bonded premises

The procedures for refunds of tax collected on imported bottled distilled spirits returned to bonded premises would be conformed to the rules for domestically produced and imported bulk distilled spirits. Thus, refunds would be available for all distilled spirits on their return to a bonded distilled spirits plant.

Authority to cancel or credit bonds without submission of records

For purposes of canceling or crediting bonds furnished when distilled spirits are removed from bonded premises for exportation, the Treasury Department would be authorized to permit records of exportation to be maintained by the exporter, rather than requiring submission of proof of exportation to Treasury in all cases.

Repeal of required maintenance of records on premises of distilled spirits plant

Distilled spirits plant proprietors would be permitted to maintain records of their activities at locations other than the premises where the operations covered by the records are carried out (e.g., corporate headquarters where tax audits currently are conducted), provided that the records are available for inspection by the Treasury Department during business hours.

Fermented material from any brewery may be received at a distilled spirits plant

Beer could be transferred without payment of tax from a brewery to a distilled spirits plant to be used in the production of distilled spirits, regardless of whether the brewery is contiguous to the distilled spirits plant. In the case of beer previously removed from a brewery, a transfer to a distilled spirits plant also could occur without the beer being first re-transferred to the brewery.

Repeal of requirement for wholesale dealers in liquors to post sign

The requirement that wholesale liquor dealers post a sign outside their place of business indicating that they are wholesale liquor dealers would be repealed.

Refund of tax on wine returned to bond not limited to unmerchantable wine

The requirement that wine returned to bonded premises be "unmerchantable" in order for tax to be refunded to the proprietor of the bonded wine cellar to which the wine is delivered would be repealed..

Use of additional ameliorating material in certain wines

The wine labelling restrictions would be modified to allow any wine made exclusively from a fruit or berry with a natural fixed acid of 20 parts per thousand or more (before any correction of such fruit or berry) to contain a volume of ameliorating material not in excess of 60 percent.

Domestically produced beer may be withdrawn free of tax for use by foreign embassies, etc.

The present-law rule applicable to domestically produced distilled spirits and wine (and imported distilled spirits, wine, and beer) which permits these products to be withdrawn from the place of production without payment of tax for the official or family use of representatives of foreign governments or public international organizations would be extended to domestically produced beer.

Beer may be withdrawn free of tax for destruction

Beer could be removed from a brewery without payment of tax for destruction, subject to Treasury Department regulations.

Authority to allow drawback on exported beer without submission of records

The requirement that proof of exportation be submitted to the Treasury Department in all cases as a condition of receiving a refund of tax would be repealed. This proof would continue to be required to be maintained at the exporter's place of business.

Transfer to brewery of beer imported in bulk without payment of tax

The present law rule applicable to distilled spirits imported into the United States in bulk containers would be extended to beer imported into the United States in bulk containers, so that imported beer could, subject to Treasury regulations, be withdrawn from customs custody for transfer to a brewery without payment of tax.

Effective Date

These proposals generally would be effective beginning 180 days after date of enactment. The provision deleting the requirement that wholesale liquor dealers post a sign outside their place of business would be effective on the date of the proposal's enactment.

Legislative Background

These proposals were included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposals also were included in H.R. 4210 (102nd Cong.), and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

B. Other Excise Tax Provisions

1. Authority for IRS to grant exemptions from registration requirements

Present Law

Under section 4222, certain sales for exempt use of articles subject to Federal excise taxes may not be made without payment of tax unless the manufacturer, the first purchaser, and the second purchaser (if any) are all registered under regulations prescribed by the Secretary.

Description of Proposal

The IRS would be allowed to provide exemptions from generally applicable excise tax registration requirements for certain classes of taxpayers (rather than only all taxpayers or individually identified taxpayers).

Effective Date

The proposal would apply to sales occurring after the 180 days after the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposal also was included in H.R. 4210 (102nd Cong.), and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

2. Repeal of certain "deadwood" provisions

Present Law

Temporary reduction in tax on piggyback trailers

Piggyback trailers and semitrailers sold within the one-year period beginning on July 18, 1984, were permitted a temporary reduction in the retail excise tax rate on trailers.

Expiration of excise tax on deep seabed minerals

The Deep Seabed Mineral Resources Act (P.L. 96-283) imposed an excise tax on certain hard minerals mined on the deep seabed. The tax revenues were intended to fund obligations of

the United States under a contemplated Law of the Sea Convention. Because the United States did not sign the treaty, this excise tax never because effective and the tax expired after June 28, 1990.

Description of Proposals

The tax reduction for piggy back trailers and the deep seabed hard minerals excise tax provisions would be repealed as "deadwood."

Effective Date

The proposals would be effective on the date of enactment.

Legislative Background

These proposals were included in H.R. 3419 (103rd Cong.), as passed by the House in 1993. The proposals also were included in H.R. 4210 (102nd Cong.), and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

3. Consolidation of aviation gasoline excise tax provisions

Present Law

Gasoline used in noncommercial (not for hire) aviation is subject to a 19.4-cents-per-gallon excise tax. 18.4 cents per gallon of this tax is collected when the gasoline is removed from a registered and bonded pipeline or barge terminal. The remaining 1 cent per gallon is imposed at the retail level.

Description of Proposal

Imposition of the aviation gasoline excise tax would be consolidated, with the entire 19.4-cents-per-gallon rate being imposed when the gasoline is removed from a terminal facility.

Effective Date

The proposal would be effective for sales or uses beginning in the first calendar quarter that starts at least 180 days after enactment.

4. Exempt Alaska from diesel dyeing requirement while Alaska is exempt from Clean Air Act dyeing

Present Law

An excise tax totaling 24.4-cents-per-gallon is imposed on diesel fuel (Code sec. 4081). In the case of fuel used in highway transportation, 17.5 cents per gallon (20 cents after September 20, 1995) is dedicated to the Highway Trust Fund. Revenues equal to 0.1 cent per gallon are dedicated to the Leaking Underground Storage Trust Fund. The remaining portion of this tax is imposed on transportation generally and is retained in the General Fund.

The diesel fuel tax is imposed on removal of the fuel from a registered and bonded pipeline or barge terminal facility (i.e., at the "terminal rack"). Present law provides that tax is imposed on all diesel fuel removed from bonded terminal facilities unless the fuel is destined for a nontaxable use and is indelibly dyed pursuant to Treasury Department regulations.

In general, the diesel fuel tax does not apply to non-transportation uses of the fuel. Off-highway business uses are included within this non-transportation use exemption. This exemption includes use on a farm for farming purposes and as fuel powering off-highway equipment (e.g., oil drilling equipment). Use as heating oil also is exempt. (Most fuel commonly referred to heating oil is diesel fuel.) The tax also does not apply to fuel used by State and local governments, to exported fuels, and to fuel used in commercial shipping. Fuel contained in (or by) intercity buses and trains is partially exempt from the diesel fuel tax.

A similar dyeing regime exists for diesel fuel under the Clean Air Act. That Act prohibits the use on highways of diesel fuel with a sulphur content exceeding prescribed levels. This "high sulphur" diesel fuel is required to be dyed by the EPA. The State of Alaska was exempted from the Clean Air Act, but not the excise tax, dyeing regime for three years.

Description of Proposal

Diesel fuel sold in the State of Alaska would be exempt from the diesel dyeing requirement during the remainder of the period when that State is exempt from the Clean Air Act dyeing requirements. Thus, dyed diesel fuel could be used in taxable uses without penalties being imposed (subject to a certification procedure to be established by the Treasury Department).

Effective Date

The proposal would be effective on the date of enactment.

5. Clarification of activities constituting manufacture for purposes of the retail truck excise tax

Present Law

A 12-percent excise tax is imposed on the sale of trucks, tractors, and trailers having a gross vehicle weight in excess of specified amounts (sec. 4051). Revenues from the tax are dedicated to the Highway Trust Fund. The tax is imposed on the first retail sale of a taxable vehicle or addition thereto.

Generally, repairs of used vehicles are treated as remanufacture (giving rise to tax on the entire vehicle) if--

(1) the transportation function of the truck is changed by additions or modifications to the chassis of the truck;

(2) a new vehicle is fabricated from a wrecked vehicle; or

(3) modifications to a used vehicle are so extensive that they extend the vehicle's useful life.

The mere addition of a fifth wheel to a taxable truck is not treated as remanufacture, although the fifth wheel itself would be taxed.

Description of Proposal

Clarification would be provided that the following activities do not constitute remanufacture when performed on a used truck or tractor chassis:

(1) removal of a fifth wheel and addition of a power take-off, hoist, and dump body; or

(2) simple addition of a power take-off, hoist, and dump body.

These activities would remain taxable to the extent of the modifications made.

Effective Date

The proposal would be effective on the date of enactment. No inference would be intended by the prospective effective date that the activities described do constitute remanufacture under present law.

VIII. ADMINISTRATIVE PROVISIONS

A. General Provisions

1. Repeal of authority to disclose whether a prospective juror has been audited

Present Law

In connection with a civil or criminal tax proceeding to which the United States is a party, the Secretary must disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service (sec. 6103(h)(5)).

This disclosure requirement, as it has been interpreted by several recent court decisions, has created significant difficulties in the civil and criminal tax litigation process. First, the litigation process can be substantially slowed. It can take the Secretary a considerable period of time to compile the information necessary for a response (some courts have required searches going back as far as 25 years). Second, providing early release of the list of potential jurors to defendants (which several recent court decisions have required to permit defendants to obtain disclosure of the information from the Secretary) can provide an opportunity for harassment and intimidation of potential jurors in organized crime, drug, and some tax protester cases. Third, significant judicial resources have been expended in interpreting this procedural requirement that might better be spent resolving substantive disputes. Fourth, differing judicial interpretations of this provision have caused confusion. In some instances, defendants convicted of criminal tax offenses have obtained reversals of those convictions because of failures to comply fully with this provision.

Description of Proposal

The proposal would repeal the requirement that the Secretary disclose, upon the written request of either party to the lawsuit, whether an individual who is a prospective juror has or has not been the subject of an audit or other tax investigation by the Internal Revenue Service.

Effective Date

The proposal would be effective for judicial proceedings pending on, or commenced after, the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

2. Clarify statute of limitations for items from pass-through entities

Present Law

Passthrough entities (such as S corporations, partnerships, and certain trusts) generally are not subject to income tax on their taxable income. Instead, these entities file information returns and the entities' shareholders (or beneficial owners) report their pro rata share of the gross income and are liable for any taxes due.

Some believe that, prior to 1993, it may have been unclear as to whether the statute of limitations for adjustments that arise from distributions from passthrough entities should be applied at the entity or individual level (i.e., whether the 3-year statute of limitations for assessments runs from the time that the entity files its information return or from the time that a shareholder timely files his or her income tax return). In 1993, the Supreme Court held that the limitations period for assessing the income tax liability of an S corporation shareholder runs from the date the shareholder's return is filed (Bufferd v. Comm., 113 S. Ct. 927 (1993)).

Description of Proposal

The proposal would clarify that the return that starts the running of the statute of limitations for a taxpayer is the return of the taxpayer and not the return of another person from whom the taxpayer has received an item of income, gain, loss, deduction, or credit.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

3. Certain notices disregarded under provision increasing interest rate on large corporate underpayments

Present Law

The interest rate on a large corporate underpayment of tax is the Federal short-term rate plus five percentage points. A large corporate underpayment is any underpayment by a subchapter C corporation of any tax imposed for any taxable period, if the amount of such underpayment for such period exceeds $100,000. The large corporate underpayment rate generally applies to periods beginning 30 days after the earlier of the date on which the first letter of proposed

deficiency, a statutory notice of deficiency, or a nondeficiency letter or notice of assessment or proposed assessment is sent. For this purpose, a letter or notice is disregarded if the taxpayer makes a payment equal to the amount shown on the letter or notice within that 30 day period.

The large corporate underpayment rate generally applies if the underpayment of tax for a taxable period exceeds $100,000, even if the initial letter or notice of deficiency, proposed deficiency, assessment, or proposed assessment is for an amount less than $100,000. Thus, for example, under present law, a nondeficiency notice relating to a relatively minor mathematical error by the taxpayer may result in the application of the large corporate underpayment rate to a subsequently identified income tax deficiency.

Description of Proposal

For purposes of determining the period to which the large corporate underpayment rate applies, any letter or notice would be disregarded if the amount of the deficiency, proposed deficiency, assessment, or proposed assessment set forth in the letter or notice is not greater than $100,000 (determined by not taking into account any interest, penalties, or additions to tax).

Effective Date

The proposal would be effective for purposes of determining interest for periods after December 31, 1995.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

4. Withholding of Puerto Rico income taxes from the wages of Federal employees

Present Law

If State law provides generally for the withholding of State income taxes from the wages of employees in a State, the Secretary of the Treasury shall (upon the request of the State) enter into an agreement with the State providing for the withholding of State income taxes from the wages of Federal employees in the State. For this purpose, a State is a State, territory, or possession of the United States. The Court of Appeals for the Federal Circuit recently held in Romero v. United States (38 F. 3d 1204 (1994)) that Puerto Rico was not encompassed within this definition; consequently, the court invalidated an agreement between the Secretary of the Treasury and Puerto Rico that provided for the withholding of Puerto Rico income taxes from the wages of Federal employees.

Description of Proposal

The proposal would make any Commonwealth eligible to enter into an agreement with the Secretary of the Treasury that would provide for income tax withholding from the wages of Federal employees.

Effective Date

The proposal would be effective on the date of enactment.

B. Tax Court Procedures

1. Overpayment determinations of Tax Court

Present Law

The Tax Court may order the refund of an overpayment determined by the Court, plus interest, if the IRS fails to refund such overpayment and interest within 120 days after the Court's decision becomes final. Whether such an order is appealable is uncertain.

In addition, it is unclear whether the Tax Court has jurisdiction over the validity or merits of certain credits or offsets (e.g., providing for collection of student loans, child support, etc.) made by the IRS that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Description of Proposal

The proposal would clarify that an order to refund an overpayment is appealable in the same manner as a decision of the Tax Court. The proposal also would clarify that the Tax Court does not have jurisdiction over the validity or merits of the credits or offsets that reduce or eliminate the refund to which the taxpayer was otherwise entitled.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

2. Awarding of administrative costs and attorneys fees

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding.

No time limit is specified for the taxpayer to apply to the IRS for an award of administrative costs. In addition, no time limit is specified for a taxpayer to appeal to the Tax

Court an IRS decision denying an award of administrative costs. Finally, the procedural rules for adjudicating a denial of administrative costs are unclear.

Description of Proposal

The proposal would provide that a taxpayer who seeks an award of administrative costs must apply for such costs within 90 days of the date on which the taxpayer was determined to be a prevailing party. The proposal also would provide that a taxpayer who seeks to appeal an IRS denial of an administrative cost award must petition the Tax Court within 90 days after the date that the IRS mails the denial notice.

The proposal would clarify that dispositions by the Tax Court of petitions relating only to administrative costs are to be reviewed in the same manner as other decisions of the Tax Court.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

3. Redetermination of interest pursuant to motion

Present Law

A taxpayer may seek a redetermination of interest after certain decisions of the Tax Court have become final by filing a petition with the Tax Court.

It would be beneficial to taxpayers if a proceeding for a redetermination of interest supplemented the original deficiency action brought by the taxpayer to redetermine the deficiency determination of the IRS. A motion, rather than a petition, is a more appropriate pleading for relief in these cases.

Description of Proposal

The proposal would provide that a taxpayer must file a "motion" (rather than a "petition") to seek a redetermination of interest in the Tax Court.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

4. Application of net worth requirement for awards of litigation costs

Present Law

Any person who substantially prevails in any action brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative costs incurred before the IRS and reasonable litigation costs incurred in connection with any court proceeding. A person who substantially prevails must meet certain net worth requirements to be eligible for an award of administrative or litigation costs. In general, only an individual whose net worth does not exceed $2,000,000 is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7,000,000 is eligible for an award. (The net worth determination with respect to a partnership or S corporation applies to all actions that are in substance partnership actions or S corporation actions, including unified entity-level proceedings under sections 6226 or 6228, that are nominally brought in the name of a partner or a shareholder.)

Although the net worth requirements are explicit for individuals, corporations, and partnerships, it is not clear which net worth requirement is to apply to other potential litigants. It is also unclear how the individual net worth rules are to apply to individuals filing a joint tax return.

Description of Proposal

The proposal would provide that the net worth limitations currently applicable to individuals also apply to estates and trusts. The proposal also would provide that individuals who file a joint tax return shall be treated as one individual for purposes of computing the net worth limitations. Consequently, the net worths of both spouses would be aggregated for purposes of this computation. An exception to this rule would be provided in the case of a spouse otherwise qualifying for innocent spouse relief.

Effective Date

The proposal would apply to proceedings commenced after the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.

C. Permit IRS to Enter Into Cooperative Agreements With State Tax Authorities

Present Law

The IRS is generally not authorized to provide services to non-Federal agencies even if the cost is reimbursed (62 Comp. Gen. 323, 335 (1983)).

Most taxpayers reside in States with an income tax and, therefore, must file both Federal and State income tax returns each year. Each return is separately prepared, with the State return often requiring information taken directly from the Federal return. Permitting the IRS to enter into agreements that are designed to promote efficiency through joint tax administration programs with States would reduce the burden on taxpayers because much of the same information could be used by both Governments.

For example, the burden on taxpayers could be significantly reduced through joint electronic filing of tax returns, whereby a taxpayer electronically transmits both Federal and State returns to one location. Joint Federal and State electronic filing could simplify and shorten return preparation time for taxpayers. Also, State governments could benefit from reduced processing costs, while the IRS could benefit from the potential increase in taxpayers who would elect to file electronically because they would be able to fulfill both their Federal and State obligations simultaneously.

Description of Proposal

The proposal would provide that the Secretary is authorized to enter into cooperative agreements with State tax authorities to enhance joint tax administration. These agreements may include (1) joint filing of Federal and State income tax returns, (2) single processing of these returns, and (3) joint collection of taxes (other than Federal income taxes).

The proposal would provide that these agreements may require reimbursement for services provided by either party to the agreement. Any funds appropriated for tax administration may be used to carry out the responsibilities of the IRS under these agreements, and any reimbursement received under an agreement would be credited to the amount appropriated.

No agreement may be entered into that does not provide for the protection of confidentiality of taxpayer information that is required by section 6103.

Effective Date

The proposal would be effective on the date of enactment.

Legislative Background

The proposal was included in H.R. 3419 (103rd Cong.), as passed by the House in 1994. The proposal also was included in H.R. 4210 (102nd Cong.) and H.R. 11 (102nd Cong.), as passed by the House and the Senate in 1992 and vetoed by President Bush.